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American Institute of Certified Public Accountants

AUDIT AND ACCOUNTING GUIDE

SAVINGS AND LOAN ASSOCIATIONS

**PREPARED BY THE COMMITTEE ON
SAVINGS AND LOAN ASSOCIATIONS**

Fourth Revised Edition

Including

STATEMENTS OF POSITION

ISSUED BY THE ACCOUNTING STANDARDS DIVISION

and

SPECIAL REPORT

**PREPARED BY THE SPECIAL TASK FORCE ON AUDITS
OF REPURCHASE SECURITIES TRANSACTIONS**

Note: This volume includes the audit and accounting guide, *Savings and Loan Associations*, as it was originally published in 1979 and Statements of Position 85-2, *Accounting for Dollar Repurchase — Dollar Reverse Repurchase Agreements by Sellers-Borrowers*, and 86-1, *Reporting Repurchase — Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations*, issued by the Accounting Standards Division in January 1985 and September 1986, respectively. In using this guide, readers should refer to the statements of position, which were not available when the guide was originally issued. This volume also includes the *Report of the Special Task Force on Audits of Repurchase Securities Transactions*. The report is not authoritative but is included for the information of readers of the guide.

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**American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, N.Y. 10036**

NOTICE TO READERS

This audit and accounting guide presents recommendations on auditing standards and procedures and financial accounting and reporting standards. Recommendations on financial accounting and reporting standards are subject to review by the Financial Accounting Standards Board.

This guide was developed by the AICPA Committee on Savings and Loan Associations and has been reviewed by members of both the AICPA Auditing Standards Board and Accounting Standards Executive Committee. It does not have the authority of a pronouncement by the Auditing Standards Board or by the Financial Accounting Standards Board or its predecessors. However, AICPA members may have to justify departures from the guide if their work is challenged.

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Transition

Generally accepted accounting principles and generally accepted auditing standards as they pertain to business entities in general are applicable to savings and loan associations. Accordingly, the accounting principles established by pronouncements of the Financial Accounting Standards Board and its predecessor bodies of the American Institute of Certified Public Accountants are applicable to savings and loan associations as specified in those pronouncements. The provisions of this guide, except for the accounting for loan commitment fees, apply to the financial statements of savings and loan associations for fiscal periods beginning after December 31, 1978.

The provisions of this guide regarding accounting for loan commitment fees are applicable to all such fees for transactions entered into after June 30, 1979. Earlier application is encouraged with respect to transactions entered into before June 30, 1979, that took place in periods for which financial statements have not previously been issued.

Chapter 1

Organization and Regulation

General Information

Savings and loan associations are corporations chartered either by the state in which they operate or by the Federal Home Loan Bank Board (FHLBB). All associations chartered by the FHLBB are known as “federal” associations and have the word “federal” in their corporate names. The majority of savings and loan associations are mutual institutions; they are owned by the savers who, together with the borrowers, are members entitled to vote at annual meetings.

Most states provide for the organization of mutual associations. In addition, several states and the FHLBB provide for capital stock associations that are authorized by state charter to issue and sell capital stock (sometimes called permanent reserve shares, guaranty stock, or guarantee stock) to investors. This capital stock represents equity capital that cannot be withdrawn, and it is not insured by the Federal Savings and Loan Insurance Corporation (FSLIC).

The applicable state laws and regulations vary but usually include requirements or restrictions concerning issuance of capital stock, such as a minimum amount of initial consideration, the rights of stockholders, or the payment of dividends. Those requirements may be considerably more restrictive than requirements generally applicable to other corporations. If the meaning and applicability of the regulatory requirements are not clear and interpretation is necessary, the auditor should request the association to obtain an opinion from an attorney or from the appropriate regulatory authority.

All federal associations are subject to the rules and regulations of the FSLIC (*Rules and Regulations for Insurance of Accounts*), the FHLBB (*Rules and Regulations for the*

Federal Savings and Loan System), and the Federal Home Loan Bank system (*Regulations for the Federal Home Loan Bank System*). State-chartered associations are subject to the laws and regulations of the state under whose charter they operate and, if federally insured, are also subject to the rules and regulations of the Federal Home Loan Bank system and the FSLIC. Uninsured members of a federal home loan bank are subject to the laws and regulations of the state under whose charter they operate and the rules and regulations for the Federal Home Loan Bank system.

Some of the rules and regulations governing both federally and state-chartered associations pertain to accounting, although the majority of regulations pertain to the maintenance of investments, savings accounts, and operations. The independent auditor should become familiar with the rules and regulations of the applicable supervisory authorities and should be informed of current revisions.

Holding Companies

In states in which capital stock associations are permitted, one or more associations may be owned wholly or in part by a company which is not a savings and loan association. Those holding companies are subject to regulations, and their acquisition of a savings and loan association is subject to prior approval by various regulatory authorities. The “Regulations for Savings and Loan Holding Companies,” contained in the *Rules and Regulations for Insurance of Accounts* set forth pertinent regulations relating to the operations of holding companies and the acquisition by holding companies of insured associations. The regulations define “unitary” (investment in one savings and loan association), “multiple” (investment in more than one savings and loan association), and “diversified” (the investment in the savings and loan association is relatively immaterial to the group) holding companies. The regulations also cover permitted activities of holding companies. During the course of the audit of an insured association care should be taken to determine that any transaction between the association and its parent holding company complies with the applicable rules and regulations.

Conversions

The FHLBB has adopted regulations that permit the conversion of a mutually chartered, federally insured savings and loan association into a capital stock association. These conversions may only occur in states that permit the operation of capital stock associations.

The regulations relating to the conversion of a federally insured association are set forth in the *FSLIC Rules and Regulations for Insurance of Accounts*. The regulations also contain extensive accounting requirements applicable to accounting and reporting for federally insured savings and loan associations. There is also a section that specifies the form and content of financial statements to be filed with a conversion application, an application for issuance of subordinated debt, and the periodic filings of publicly held savings and loan associations registered with the FHLBB under the Depository Institutions Amendments of 1974 Act (formerly filed with the Securities and Exchange Commission (SEC) under the 1934 act requirements).

Insurance of Savings Accounts

Associations have various types of savings accounts, as authorized by supervisory authorities. These accounts may include passbook savings accounts, savings certificates, investment certificates, withdrawable or repurchasable shares, and others. Savers in a federal mutual association, as the members of the association, are entitled to one vote for each \$100 or fraction thereof of the withdrawable value of any savings account held by each member. Each borrower member may cast one vote as a borrower. No member may cast more than 400 votes. In some states, the savers in capital stock associations are also members with similar voting rights; in others, the savers have a creditor relationship.

The savings accounts of all federal savings and loan associations are required to be insured by the FSLIC under Title IV of the National Housing Act, as amended. Other eligible savings and loan, building and loan, homestead associations, and cooperative banks may also obtain such insurance from the FSLIC.

Basis of Accounting

The accrual basis of accounting is the only acceptable basis of accounting under generally accepted accounting principles for business enterprises. Regulations of the FHLBB require that insured institutions, with certain exceptions, prepare their financial statements on the accrual basis of accounting.

The auditor may, however, encounter other bases of accounting, such as the cash and the modified accrual bases. Under the modified accrual basis, an association may record certain items, such as interest income from investments and interest expense on borrowed money, on the accrual method, whereas other items of income and expense may be recorded on the cash basis. If there are material variations from generally accepted accounting principles caused by the basis of accounting, the independent auditor should be guided by the provisions of SAS no. 14, *Special Reports*.

Independent Audits and Supervisory Examinations

Under *Rules and Regulations for Insurance of Accounts*, all federal associations and state-chartered associations whose accounts are insured by the FSLIC are subject to examination by the Office of Examinations and Supervision (OES) of the FHLBB. Frequently, joint examinations of state-chartered associations are made by OES and by the state regulatory authority that examines and supervises such associations.

The scope of state supervisory examinations of state-chartered associations that have independent audits varies from one state to another. It is not practical to cover the policy of each state in this guide; however, in some states the policies are quite similar to that of federal authorities.

Regulations of the FHLBB require that each insured institution be audited at least once in each calendar year by auditors and in a manner satisfactory to the FSLIC. (In a few prescribed circumstances, this requirement may be waived.) The audit requirement is satisfied if the audit is conducted by independent public accountants or, if specified conditions are met, by internal auditors. The independent auditor should be thoroughly familiar with the rules and regulations of the FHLBB regarding audits of insured institutions. Present

regulations deal with such matters as requirements for audits qualifications of public accountants, independence of public accountants, and reports of audits. A publication entitled *Federal Home Loan Bank Board Annotated: Manual of Statutes and Regulations* (3d ed., 1976) is available from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402. Order forms are available from the district director—examinations of each FHLBB district.

The OES makes a supervisory examination (as distinguished from an audit) principally to ascertain whether an association is operated soundly and in accordance with the applicable laws and regulations. To accomplish the objective of the supervisory examination, the examiners usually do not perform all of the audit procedures required by generally accepted auditing standards to express an opinion on financial statements.

The OES of the FHLBB has published informative bulletins setting forth certain requirements regarding audits of insured institutions. Public Accountant (PA) bulletins issued by the OES prescribe certain standards for the audits of federally insured associations.

The FHLBB also issues series of memoranda designated “R” and “T.” The Office of General Counsel (OGC) of the FHLBB issues opinions and interpretations. The “R” memoranda cover instructions to the FHLBB staff and supervisory agents relating to rules and regulations, interpretations and opinions, statements of policy, and other matters that affect the general public. The “T” series deals primarily with technical matters and may apply to only a relatively limited number of institutions.

Copies of the current FHLBB statements of accounting and auditing policies and PA bulletins can be obtained from the district director—examinations in each FHLBB district.

The American Bar Association has published a *Handbook of Savings and Loan Law* which contains a description of the applicable laws relating to savings and loan associations, together with suggested references. Copies may be obtained from the American Bar Association, 1155 East 60th Street, Chicago, Illinois 60637.

Chapter 2

Auditing—General

Planning the Audit

Thorough planning is important to the successful examination of the financial statements of a savings and loan association. The general information needed for this purpose is usually developed by a preliminary review of financial information and data and should include a review of regulatory reports and correspondence received by an association from federal and state authorities. Statement on Auditing Standards no. 22, *Planning and Supervision*, should be consulted to obtain general guidance on audit planning.

Examples of the types of information that may be assembled and the arrangements to be considered when planning the audit include:

1. *General*

- Engagement letter (including FHLBB and other regulatory requirements)
- Location of offices
- Office hours of employees
- Hours opened to the public for business
- Audit personnel requirements—interim and year end
- Letters of accreditation for audit personnel
- Types of teller posting machines and other bookkeeping or data processing equipment
- Daily closeout procedures
- Audit confirmation supplies

2. *Internal Accounting Control*

- Preliminary evaluation—procedure manuals and organization charts
- Preliminary evaluation—main office and branches
- Preliminary evaluation—data processing installations (including service bureaus)

3. *Cash*

Number of tellers

Number of bank accounts

Approximate volume of receipts and disbursements
(number of transactions), etc.

Number and location of cash funds (other than teller
funds)

4. *Control of Cash Equivalent Items*

Location of securities

Location of consigned items, such as savings bonds,
travelers checks, etc.

5. *Loans*

Number of accounts by major classes of loans

Loans and participations purchased or sold

Location of detail and control accounts

Location of all collateral and supporting documentation

6. *Savings Accounts*

Types of accounts offered

Number of accounts

Location of detail and control accounts

Interest payment dates

Accounts which request "no correspondence"

Dormant account procedures

7. *Other Items*

Parent of the association

Subsidiaries of the association, service corporations,
joint ventures, and real estate development projects

Major accounting policies

Related parties

Types of borrowed funds:

FHLB advances, subordinated debt, mortgage backed
bonds, bank loans, etc.

Timing of the Audit

The FHLBB requires that each federally insured association be audited at least once in each calendar year. Two copies of the auditor's report must be furnished to the FHLBB. Generally, the date of the independent audit does

not need to coincide with the fiscal year end of the association; however, the audit period must cover twelve calendar months. The audit date may be agreed upon with the association, but, in many cases, the independent auditor can time the audit to avoid conflict with the federal and state examinations. The independent auditor should notify the appropriate supervisory authorities well in advance of the proposed commencement date of the independent examination. Timing of the audit also may be affected by an association's plans for changes in personnel, office space, and accounting systems or equipment.

Reconciliation of Net Worth. The FHLBB also requires that the notes to the financial statements submitted to it include a reconciliation of net worth reported in the audited financial statements, with the net worth reported in other reports to the FHLBB as of the same date. A separate reconciliation schedule is usually acceptable for this purpose.

Other Regulatory Audit Considerations. Federally insured associations are required to submit periodic reports to the FHLBB. Usually state-chartered associations are required to submit, at least annually, a report to state authorities.

The rules and regulations of various state supervisory authorities should be reviewed to determine whether an independent auditor's opinion on financial statements is required in annual reports filed by a state association with state supervisory authorities. Holding companies are subject to reporting requirements of the FHLBB and may be subject to the reporting requirements of the SEC. Associations may be subject to federal securities laws, and in certain cases the FHLBB has the authority to administer and enforce those laws.

The independent auditor should ascertain the requirements of federal and state supervisory authorities regarding the time for submitting reports. The independent auditor's reports should be rendered to the association and the association should submit the required copies to the appropriate supervisory authorities.

Initial Audit Procedures

To the extent possible, audit procedures should be executed with a minimum of disruptions in an association's regular routine. Therefore, before beginning the audit, consideration should be given to assembling the staff assigned to the engagement and briefing it in regard to particular audit requirements. Specific assignments may also be made.

Letters of accreditation should be obtained from the association to assure that the auditor's personnel can gain access to each association office when the field work is begun. Upon entering the association, the letters should be presented. If a surprise examination of selected key areas is conducted, control over the areas should be established immediately. The extent of control should be determined before starting the field work, based on the auditor's understanding of the internal accounting controls inherent in the system and the materiality of items involved. A listing of several areas in which immediate control should be considered includes cash on hand, investment securities and consigned paper on hand, passbooks and certificates held as collateral for loans on savings accounts, and subsidiary ledgers of loan and savings accounts. If necessary, securities and reserve or vault cash may be sealed to be counted later. Audit personnel should determine that the totals of loan and savings subsidiary ledgers are in agreement with the general ledger control accounts. At completion of the subsidiary ledger work, confirmation requests may be prepared. Early in the audit, personnel in charge of the various segments of the audit work should begin an evaluation of the internal accounting controls and note significant weaknesses that may require modifications of auditing procedures.

Internal Accounting Control

The second standard of field work states "there is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." This section is intended to assist the auditor in complying with the second standard as it applies

to the study and evaluation of internal accounting controls in savings and loan associations.

The nature of the audit procedures selected, their timing, and the extent of their application will depend to a considerable extent on the degree of reliance the independent auditor intends to place on the system of internal accounting control. The auditor's study and evaluation of the system of internal accounting control, as a basis for determining the scope of the work, involves both the initial inquiry necessary to ascertain the association's procedures and such further investigations, tests, and inquiries during the audit as may be necessary to evaluate compliance with established internal accounting control procedures—that is, whether the controls are functioning as represented.

Section 320 of Statement on Auditing Standards no. 1 (SAS no. 1) amplifies and clarifies the application of the basic concepts and rationale included in the second standard of field work as guidance to proper study and evaluation of internal accounting control. The existence of an internal audit function may affect the study and the evaluation of internal accounting control. The auditor should be familiar with SAS no. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*.

Internal accounting controls over cash, consigned items, loans receivable, securities owned, savings accounts, escrow accounts and advances for taxes and insurance, and the handling of transactions related to these items are of particular importance in savings and loan associations. For example, cash-handling functions should be segregated, to the extent practicable, from related record-keeping responsibilities. Adequate controls should be established over savings accounts, including inactive accounts, and over lending procedures, including loan approvals, appraisal reports, document control, and the disbursement of loan proceeds.

Many associations utilize some form of electronic data processing (EDP) system. These systems may be operated solely by an association, shared on a cooperative basis with others, or provided by an independent organization supplying specific data processing services for a fee. The auditor should study and evaluate the internal accounting control features of the

EDP system as he does other features of internal accounting control over the association's operations. The effect of EDP systems on auditing procedures is discussed in the section entitled "Auditing and EDP Systems."

Some associations are initiating procedures for specialized activities, such as direct deposit of social security checks, handling customers' transactions through point-of-sale terminals which utilize plastic cards, and payments to third parties authorized by savers. The auditor should study related internal accounting controls over such activities and evaluate those controls as a basis for determining the nature, extent, and timing of audit tests to be applied in the examination.

In evaluating internal accounting controls, the independent auditor should also be familiar with the FHLBB regulatory pronouncements on conflicts of interest and should examine the corresponding policy established by the association. The results of the association's most recent efforts to determine adherence to such policy and regulations should be reviewed. In addition, the auditor should be familiar with SAS no. 6, *Related Party Transactions*. This statement provides guidance on how to identify related party transactions when performing an examination and to satisfy the auditor about the substance of, and accounting for, such transactions.

Adequate fidelity bond coverage and an accounting system with appropriate internal accounting controls are essential elements in minimizing losses and discouraging irregularities and illegal acts. Although the objective of an independent auditor's examination is to support an opinion on the financial statements, it may also assist in minimizing losses and discouraging irregularities and illegal acts. In this regard, the auditor should be familiar both with the guidelines set forth in SAS no. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities* and SAS no. 17, *Illegal Acts by Clients* and with regulatory requirements.

If the independent auditor's evaluation of internal accounting control, made for the purpose of determining the nature, timing, and extent of audit tests, reveals material weaknesses in the system, the FHLBB and SAS no. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, require that such weaknesses be reported to the

association. The FHLBB requires that recommendations also be made for procedural changes to strengthen existing internal accounting control. A letter or report to the association concerning such recommendations must be filed by the association with the FHLBB district director—examinations. Some states have similar requirements.

Confirmation Procedures

Many of an association's significant accounts may be subject to confirmation procedures. They include the following:

1. Cash in banks.
2. Investments and securities held in safekeeping by others or held by others as collateral for loans or advances.
3. Loan accounts, including accounts previously written off.
4. Loans serviced by and for others.
5. Real estate sold on contract.
6. Savings accounts.
7. Advances from the FHLB and other borrowed money.
8. Consigned items, such as savings bonds and travelers checks.
9. Advance payments from borrowers for taxes and insurance.
10. Commitments (loans, securities, etc.).
11. Customers' securities held in safekeeping.

The techniques followed in carrying out confirmation procedures for a savings and loan association should not differ from those used in other audit engagements and should include the following:

1. Agreeing the total of the listings of accounts from which the confirmation selection is made with the control account.

2. Agreeing data on the confirmation requests with the association's records.
3. Maintaining control of the requests until mailed in envelopes with the auditor's return address. The mailing may include return envelopes addressed to the auditor.
4. Mailing second (and, in some cases, third) requests when positive confirmations are used on accounts for which replies have not been received and performing alternative procedures on accounts for which no replies are received.
5. Reconciling differences and clearing exceptions reported on replies.
6. Reviewing the results of confirmation requests to determine, among other things, if any significant weaknesses in internal accounting control have been disclosed and whether additional audit procedures should be applied.
7. Completing documentation in the working papers of all confirmations sent, exceptions noted, and the resolution of the exceptions.

Application of Statistical Sampling

In audits of savings and loan associations, a number of auditing procedures lend themselves to statistical sampling. They include tests of transactions to determine compliance with specified internal accounting control procedures and substantive tests of balances, such as tests of savings and loan accounts. The auditor may consider using statistical sampling in these and other areas.

To provide guidance to auditors who want to use statistical sampling, section 320 of SAS no. 1 includes two appendices. Section 320A, "Relationship of Statistical Sampling to Auditing," provides a discussion of matters to be considered in applying statistical sampling and in correlating its use with other aspects of an audit. Section 320B, "Precision and Reliability for Statistical Sampling in Auditing," provides guidance to the auditor who has decided to use statistical sampling. It includes discussion and examples that are intended

to aid an auditor's judgment in determining precision and reliability for statistical sampling.

Auditing and EDP Systems

The use of electronic data processing equipment in business does not in any way affect the objective of the audit. However, organizational and control procedures used in electronic data processing may differ from those used in manual or mechanical data processing, and audit procedures applied to accounting records maintained on EDP equipment may vary from those applied to records maintained manually or on mechanical equipment. This guide does not discuss the effects of EDP on an audit. If EDP processing is significant, SAS no. 3, *The Effects of EDP on the Auditor's Study and Evaluation of Internal Control*, provides useful guidance. That statement provides guidance to assist an independent auditor in evaluating the system of internal accounting control as a basis for determining the nature, extent, and timing of audit procedures. In addition, the AICPA has issued an audit guide, *The Auditor's Study and Evaluation of Internal Control in EDP Systems*, which should also be consulted. Also, if applicable, consideration should be given to the AICPA publication, *Audits of Service-Center-Produced Records*. That audit guide applies to significant accounting applications that are processed at computer centers and bureaus servicing savings and loan associations. Appendix C of that guide presents a case study illustrating a review of a service center where financial data for many savings and loan associations are processed with standardized programs. The FHLBB issues bulletins discussing certain requirements for auditing in an EDP environment.

Branch Offices

Federal regulations provide that a branch office must be directed from its home office and that generally the home office shall maintain control records of all business transactions at each branch. However, detailed records of all of its transactions may be kept at each branch.

The audit program may be the same for a branch office as for the main office of the association and, in many instances, the examination of the branch offices will be undertaken simultaneously. Associations with branch offices use one of three general systems of accounting:

1. A centralized system in which the home office maintains all primary and subsidiary ledgers, including individual savings and loan ledgers for the branch office accounts.
2. A decentralized system in which the branch office maintains its own general and individual account ledgers as if it were a separate association.
3. A system that is partially centralized and partially decentralized.

The extent of the independent auditor's examination of branch office accounts and supporting detail will depend on the accounting system used and the effectiveness of the system of internal accounting control. Cash and securities counts, confirmation programs, and balancing of various subsidiary ledgers usually are conducted simultaneously at all locations if there are only a few branch offices or if the system of internal accounting control is not considered adequate. However, if the auditor believes the internal accounting control over branch offices is satisfactory, audit procedures may be applied to selected branch offices at various times before completing the examination.

Charter, Bylaws, and Minutes

Charters for federal savings and loan associations are issued by the FHLBB. The form of bylaws of such associations is also prescribed by the FHLBB. For state associations, the form of charter and bylaws is established by the state regulatory authority.

The requirements of the charter and bylaws should be reviewed at the start of the audit. The audit program should include procedures that may be necessary to determine compliance with charter and bylaw requirements that may have a material effect on the financial statements.

Minutes of the meetings of the directors, committees of directors, operating committees, and the members or stockholders should be read, and items that may have a significant effect on the financial transactions of the association should be noted. The independent auditor should then determine whether material transactions included have been executed and recorded in accordance with the minutes and whether the minutes are approved.

In addition to items usually included in corporate minutes, the minutes of an association in most cases include approvals of loans, transactions in real estate acquired by foreclosure or for investment, transfers to and from general reserves and income tax reserves, purchases and sales of securities, the borrowing of funds from the FHLB or other sources, authorization and designation of terms of certain types of savings accounts, and interest rates on savings accounts.

Important transactions or matters that require action by the directors, the members, or the stockholders (under the charter, the bylaws, or established practice), but that are not covered in the minutes, should be called to the attention of the proper officers for appropriate action. If the matters involved may have a material bearing on the financial statements, the independent auditor should be satisfied that appropriate action is taken before releasing the audit report.

Compliance With Supervisory Regulations

The independent auditor should test compliance with supervisory rules and regulations that might materially affect the association's financial position or its results of operations. Certain regulatory requirements that may affect the financial statements are measured periodically throughout the year. The independent auditor should ascertain that the association has a system to monitor compliance with those regulations and review one or more periods of the association's files to determine whether the association's system is functioning properly. Responsibility to comply with supervisory rules and regulations rests with management; accordingly, the auditor should report to appropriate officers any failure to comply with rules and regulations that come to his attention

during the conduct of his examination. However, if the auditor encounters significant failures to comply with rules and regulations, he should consider communicating his findings to the board of directors, or its audit committee, if applicable (see SAS no. 17, *Illegal Acts by Clients*).

Associations that have been chartered by the various states as either stock or mutual associations are subject to regulation by the states in which they are chartered. State regulatory requirements and FHLBB requirements may differ. Also, it has been noted that practices of the FHLBB districts may vary. Care should be taken to review compliance with the respective requirements of the FHLBB, the FHLBB district, and the states in which the association operates.

Chapter 3

Accounting Principles and Auditing Procedures

Cash

The procedures used to test cash transactions and balances in savings and loan associations are essentially the same as those used in any other business entity.

If it is appropriate to conduct surprise cash counts, it may be advisable for the independent auditor to obtain advance permission to make such counts during the year. To make a surprise count of cash, the independent auditor should assign sufficient staff to control, count, and reconcile the cash with the control accounts. Simultaneous control should be maintained over negotiable securities until a satisfactory accounting has been made for both cash and securities. Consideration should be given to reconciling or examining the reconciliations of bank accounts in connection with the cash counts in addition to the examination of reconciliations made during the audit. Undeposited receipts on hand at the time of the cash count should be controlled until deposited. Any items included in the deposit that are subsequently returned "unpaid" should be investigated.

The independent auditor should identify, through preliminary investigation, current inquiry, and observations, other items to be controlled while the cash count is under way. The auditor should be alert to possible concealment of a material cash shortage by conversion or substitution of securities or other assets. The independent auditor may find unrecorded receipts, escrow funds, unissued government bonds, money orders, travelers checks, or other items that he should control. Confirmation of the inventories of savings bonds, money orders, travelers checks, and similar items usually should be obtained.

Some associations delegate the disbursement of mortgage loan settlement funds to agents or trustees. The independent auditor should be satisfied that the procedures used by the agents or trustees provide that funds advanced by the association are recorded, deposited and disbursed as intended. The auditor should also establish, by confirmation or by count, the amount of cash funds held by a trustee or an agent for the account of the association at the audit date.

Investments in Securities

Securities may be held for investment or, in certain instances, in a trading portfolio. The types and amounts of securities are often determined by the board of directors or by investment committee action. The securities may be on hand, with a safekeeping agent, awaiting delivery, or pledged. In addition to regular purchases and sales of investment securities, an association may also sell securities short, make commitments for future purchases, obtain borrowed funds through the use of securities sold under agreements to repurchase (repos), engage in swaps and arbitrage transactions, or act as an agent or dealer. Transactions in mortgage futures are discussed on page 23, "GNMA Futures Transactions."

Securities on hand should be counted or placed under control at the time of the cash count. Securities held by a safekeeping agent should be confirmed with the agent. When securities are in an independent safe deposit box, the count can be made within a reasonable period before or after the cash count date, provided arrangements have been made in advance with the safe deposit company to furnish the independent auditor with a letter stating that there was no access to the box in the intervening period.

All stock certificates and registered bonds should be in the name of the association or, if they are in the names of others, they should be properly endorsed or accompanied by a power of attorney. When counting coupon bonds, it should be determined that unmatured coupons are intact.

Transactions during the audit period should be test checked against broker or dealer invoices, advices or other supporting data, and appropriate minutes for approval. Where appropri-

ate, the certificate numbers of the securities owned should be test checked with the record of security purchases and sales.

Savings and loan associations that are members of the FHLB system are required to maintain a specified investment in shares of FHLB stock. The independent auditor should obtain confirmation from the district FHLB of the stock owned in compliance with this requirement. The dollar amount of these shares should be compared with the association's general ledger.

Federal and state regulations restrict the types of investment securities that may be purchased by savings and loan associations. The independent auditor should be familiar with such regulations. In some jurisdictions, savings and loan associations may be permitted to invest in equity securities. In those instances, the provisions of FASB Statement no. 12, *Accounting for Certain Marketable Securities*, and related interpretations apply.

In the majority of the situations, savings and loan associations invest in debt (primarily United States government) securities. Therefore, in most instances, investments made by savings and loan associations are in securities that have been excluded from the provisions of FASB Statement no. 12. The following discussion on accounting for securities pertains to those excluded investments.

Securities should be recorded at cost, including expenses incident to acquisition. Premiums and discounts should be amortized against investment income. The "interest" method as described in APB Opinion no. 21 is the preferable method for amortization of premiums and discounts, and the period of amortization usually should extend to the security's maturity date. If the obligation has been issued with a call date falling before maturity, premiums should be amortized to the earlier call date, while discounts should be amortized to maturity.

A parenthetical disclosure of market values should be made in the financial statements or the notes. Securities that are pledged for bank borrowing or other purposes should be disclosed in the financial statements or the notes.

Market values of individual securities should be obtained from published quotations or other independent sources and

compared with their carrying amounts. Since changes in the market price of government obligations are usually related to fluctuations in interest rates, no allowance for a decline ordinarily is necessary if management intends to and has the ability to hold the securities to maturity. If a decline in market value of securities is judged to be temporary, the parenthetical disclosure of market values in the financial statements or the notes is adequate. However, if it is probable that the amortized cost will not be realized at maturity (permanent impairment) the estimated loss should be recognized by charging current operations and reducing the carrying amount of the investment.

In determining whether there is a permanent impairment, an association should consider various factors, including management's intentions, its ability to hold until maturity, supervisory directives, regulatory requirements, and other circumstances. A reduction in the carrying amount of the investment because of permanent impairment should be considered to establish a new cost basis. Market recoveries in subsequent periods, if any, should not be recognized until realized upon sale or other disposition.

Losses not previously recognized and gains from security transactions should be recorded in the statement of operations for the period in which securities are sold or are otherwise disposed.

A savings and loan association may loan cash to a member bank of the Federal Reserve System. Such loans are commonly referred to as "federal funds." Ordinarily, such loans are for one day only, with the lending association regaining its funds on the business day following the loan. If material, the amount of such loans should be disclosed separately in the financial statements.

An association may invest in short-term repurchase agreements, commonly referred to as "repos." These transactions represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers will repurchase the securities within a very short period of time, usually a few days. If material, these investments should be disclosed separately in the financial statements.

An association may also borrow under repurchase agreements, commonly referred to as "reverse repos." In substance,

these arrangements represent borrowings collateralized by the related securities. When funds are borrowed under this arrangement, a liability should be established for the amount of the proceeds. The investment security account should not be relieved of the collateral securities. Interest on reverse repos should be reported as an expense and not shown net of interest income.

Associations may sell securities short. A liability should be established equal to the proceeds from the short sale. A loss should be recorded if the securities that must be acquired to complete the short sale have a market price greater than the proceeds of the short sale. No gain should be recorded until the short sale is completed.

If the association owns securities identical to those it has sold short, referred to as “short sales against the box,” the transactions should be treated as complete for accounting purposes, and gains or losses recognized accordingly. If the association subsequently purchases the securities to be delivered in satisfaction of the short sale, the price of the new purchases should be recorded as the cost of the investment securities.

Investments in Mortgage-Backed Securities, GNMA Futures, and Loans

Investments in Mortgage-Backed Securities

Mortgage-backed securities in the form of bonds and “pass through” certificates are becoming a common vehicle to facilitate the secondary mortgage market. Such securities provide a means for associations to invest available funds in easily transferable packages of real estate loans or to sell such packages to generate needed cash.

Bonds are issued with a fixed principal balance and a stated interest rate for a definite term. These securities are issued by the Federal National Mortgage Association (FNMA) and are authorized for issuance by the Government National Mortgage Association (GNMA). Bonds of this type are secured by mortgage loans (both conventional and government guaranteed) and provide for periodic interest payments. The principal balance is due at maturity. Such bonds should be classified as investment securities.

Pass-through certificates guaranteed by GNMA are issued by associations that pool qualifying loans (currently VA and FHA mortgage loans) of equal interest rate and approximately the same maturities. The certificates are issued with a stated minimum principal amount and a fixed interest rate on the unpaid principal. (The Federal Home Loan Mortgage Corporation issues similar participation certificates.) Such certificates are amortized by the repayment of a fixed amount of principal and interest over the term of the certificate. The issuer maintains records of security holders and remits principal and interest payments monthly. Additionally, a pro rata return is distributed to the holders in the event of a loan principal prepayment or payoff. The issuance of the certificates is similar to the conventional mortgage servicing arrangement. When the certificate is sold to a third party, a sale of the pool of mortgages backing the security is deemed to have taken place. A resulting gain or loss on the sale should be recognized at the time of the sale.

Investments in pass-through certificates have some characteristics common to investment securities; however, they more closely approximate a participating interest in real estate loans. Accordingly, an investing association should account for those investments in a manner consistent with other participating interests in real estate loans. A premium or discount should be amortized to provide for a substantially constant yield over the expected term of the related loans (that is, the period approximating the estimated average life of the loans in the pool).

The Internal Revenue Service has ruled that mortgage-backed securities issued in the form of "pass-through" certificates owned by a savings and loan association qualify as "loans secured by an interest in real property" for purposes of the tax definitional requirements and as "qualifying real property loans" for purposes of the bad debt deduction provisions.

GNMA Futures Transactions

Some savings and loan associations may engage in transactions in the GNMA futures market operated by the Chicago Board of Trade. Federally chartered associations must comply

with regulatory requirements including a prohibition against speculation in the futures market. Associations may hedge against price risk by buying (long hedge) or selling (short hedge) futures contracts to offset transactions in the cash market. Except for recording margin deposits, no accounting entry is generally required until the futures contract is closed. Realized gains and losses on closed futures transactions should be matched to the related cash market transactions. Accordingly, if an association hedges to protect itself against sales in the cash market, the gain or loss from the futures contract should be reflected as part of the gain or loss on the loans sold in the cash market. If an association has entered into a futures contract to hedge against sales of loans in the cash market, write-downs to market of loans held for sale may be confined to the unhedged portion of the loan inventory.

Gains or losses from futures contracts entered into to hedge against price fluctuations in originating or purchasing loans for investment should be deferred and amortized over the expected life of the related loans.

Since savings and loan associations are only permitted to engage in hedging rather than speculation in futures contracts, such contracts should be treated as closed at any time it becomes known that the expected cash transactions will not occur, and the futures contracts should be carried at market thereafter. If a futures contract is not closed at the time the transaction takes place in the cash market, the rollover of the futures contract should be marked to market and adjusted to market at each financial reporting date. Thereafter, futures contracts that do not represent positions taken as hedges against price fluctuations in originating, purchasing or selling loans should be adjusted to market at each financial reporting date.

The auditor should study and evaluate internal accounting controls over mortgage futures activities, including authorization of transactions, separation of duties, and adequacy of records. Other audit procedures should include confirmation of open contract terms and amounts, examination of support for completed transactions, and determination that closed and open contracts have been properly accounted for.

Loans

The various types of loans made by associations are discussed in the following paragraphs. The auditing procedures applicable to loans in general are discussed under "Auditing Loan Accounts."

Mortgage Loans. The principal business activity of savings and loan associations is supplying money for mortgage loans secured by real estate. The various supervisory authorities place many restrictions on such loans. These restrictions include, but are not limited to, matters such as loan-to-value limits, authorized lending areas, loans to one borrower, loans to officers, directors, or employees of associations, and the aggregate amount of loans on certain types of properties. In addition, associations must follow certain rules of investment in mortgage loans to qualify for the federal income tax benefits afforded savings and loan associations. Furthermore, an association's board of directors often adopts additional limitations. The independent auditor should be generally familiar with lending rules, regulations, and policies and should bring to the attention of management any apparent noncompliance.

Construction Loans. There are two principal types of construction loans, although variations may be encountered. One type is a loan to the owner of the property during the construction period only, with long-term financing arranged with a lender other than the association. The second type is a loan granted to finance the owner-builder during the development of one or more real estate parcels; when the real estate is sold, the loan is converted to a long-term mortgage loan either through an assumption agreement with the purchaser or through a new loan. On an assumption, the owner-builder who was the original obligor usually is released from secondary liability.

As construction progresses, requests are made by the builder for disbursement of portions of the loan proceeds. The project should be inspected by the association to determine that construction has progressed to the point permitting

the disbursements requested. The builder generally obtains waivers of lien from subcontractors and materials suppliers before disbursements are made by the association.

Auditing procedures should be adapted to the variety of construction lending practices. The independent auditor should review the association's policies and procedures regarding construction loans and make tests of origination, approval, inspection, and disbursement procedures. The auditor should recommend that associations prepare operations manuals setting forth policies and procedures. Such manuals are beneficial in the administration of loan operations and assist the independent auditor in carrying out an examination of lending procedures.

The independent auditor should be satisfied that management is evaluating the loans regularly and is providing for losses in accordance with the provisions of FASB Statement no. 5. Construction loans frequently involve high risks and deserve careful evaluation in considering an association's loan loss allowance. Many builders operate with minimum permanent capital and some keep poor records. Given this combination of factors and others, some builders overextend their lines of credit. A builder may incur losses in a project before he is aware of the losses, or the builder may have difficulty selling homes and thereby fail to generate funds needed to complete other homes already under construction. The auditor should be alert to overconcentration of loans on large real estate developments when homes are not being easily sold. When losses or delinquencies arise on loans secured by real estate developed by a builder, the auditor should review other loans granted to the same builder. Similarly, if losses arise or delinquencies occur on loans secured by real estate concentrated in one location, the auditor should review loans on other properties in the location.

The independent auditor should consider visiting selected sites to confirm the existence of the buildings under construction and to observe their progress toward completion. He should then compare his own observations with the association's inspection reports and the builder's completion reports. In some circumstances the independent auditor should

consider obtaining an independent evaluation of the status of construction (see SAS no. 11, *Using the Work of a Specialist*). Any apparent variances should be examined further and discussed with the appropriate officials of the association; provisions should be made for possible losses. See the section entitled "Accounting for Real Estate Acquired Other Than by Troubled Debt Restructurings" for a discussion of provisions for losses and evaluation of allowances.

Land Development Loans. Development refers to installing improvements on unimproved land in order to make building sites ready for construction. Land development loans include (1) loans on developed building lots, (2) loans to finance the acquisition and the development of unimproved land, and (3) loans on unimproved land. If an association is permitted by regulation to make loans on unimproved land, land held by the association for development may be sold to builders with a view toward generating a demand for construction and long-term mortgage loans.

Property Improvement Loans. Associations may make the following types of property improvement loans: FHA-insured loans, VA-guaranteed loans, and uninsured loans. These loans are for the purpose of financing alterations, repairs, and improvements to real property. They are usually made on a monthly amortization basis and are generally unsecured. However, associations occasionally require collateral and frequently a lien will be recorded in the public records. VA-guaranteed improvement loans are rarely encountered. Loans made during the period under examination should be tested for compliance with the association's established policies.

Associations holding property improvement loans may have acquired them from building material and supply companies or other parties. Dealer-originated loans usually are purchased without recourse. However, if the loans are not insured, the association may require a dealer reserve and, in addition, may hold back a portion of the proceeds until the loans are paid down to a certain amount. Losses the association sustains on these loans are generally charged against the dealer's reserve and holdback accounts. Confirmation of

reserves and holdbacks should be considered, and charges to such accounts should be reviewed to determine whether they are in accordance with the terms of dealer agreements. Loans paid off before maturity should be tested to determine whether the rebates allowed conform to the association's policies and FHA regulations, if applicable.

The required documentation for property improvement loans generally is as follows: (1) a note, endorsed if appropriate, (2) a completed loan application executed by the borrower, (3) a contractor's completion report executed by the contractor or the borrower, or both, (4) an FHA insurance report, if applicable, (5) a credit report, (6) a truth-in-lending statement, and (7) evidence of additional collateral, if any. Other than the FHA insurance report, and, sometimes, contractors' completion reports, the documents required for uninsured loans are similar to those required for insured loans.

Loans on Savings Accounts. Associations are permitted to loan money to savers on the security of their savings accounts. The form of the note varies among associations. However, it usually contains an assignment of collateral and a clause to the effect that the association has the right to withdraw from the collateral savings account the loan amount due on maturity or on failure to carry out terms of the note. Assignment of the savings account as collateral may be by an executed restrictive withdrawal slip.

The collateral should be maintained under control since unrestricted access to the passbooks or certificates may provide an opportunity for unauthorized withdrawals. It is also important that the individual savings account records clearly designate the pledged status.

In addition to the auditing procedures applicable to loans in general as discussed under "Auditing Loan Accounts," the independent auditor should review the method of granting loans on savings accounts and the nature of the internal accounting controls in effect, and selectively test the account balances to determine that they are sufficient to secure the loans.

Education Loans. Education loans are generally unsecured loans to students or their parents. Some of these loans

are insured or guaranteed by governmental agencies and the applicable regulations should be reviewed. The auditing procedures discussed under “Auditing Loan Accounts” apply.

Mobile Home Loans and Other Consumer Loans. The FHLBB and some state regulations permit associations to invest in purchase money financing, inventory financing of mobile homes, and certain other types of consumer loans. The auditing procedures discussed under “Auditing Loan Accounts” apply.

In addition, a discussion of the auditing requirements and accounting principles relating to these types of loans appears in the AICPA Industry Audit Guide, *Audits of Finance Companies*.

In certain jurisdictions, associations may make loans other than those discussed above. Appropriate audit procedures applicable to these loans should be applied in addition to those discussed under “Auditing Loan Accounts.”

Loans Serviced by Others. Many associations own or have participation interests in mortgage loans that originated in distant areas. The loans or participations may have been purchased from other associations, savings or commercial banks, or insurance or mortgage companies. The sellers generally continue to service the loans.

Auditing procedures that should be considered for such loans and participations include a review of the minutes of the board of directors meetings for authorization, document inspection, including review of participation agreements, confirmation of loan balances with borrowers, confirmation of balances due from other institutions, tests of transactions, and review of delinquent accounts. Depending on the significance of amounts of such loans and participations, the independent auditor may consider using one of the following methods for performing the audit tests considered necessary in the circumstances.

1. Obtain from the servicing organization’s own independent auditors a letter confirming the extent to which their examination included confirmation and other procedures for such loans and the results. If deemed neces-

- sary, arrange to review the audit work papers of the servicing organization's independent auditor.
2. Engage the servicing organization's independent auditors or other local independent accountants to confirm such loans and perform other tests on the basis of the scope established by the primary auditor. The timing of the examination of the client and the special work at the servicing organization should be considered so that the procedures can be applied reasonably concurrently.
 3. Confirm with the servicing organization itself, in place of other procedures, if the amounts are not material and the servicing organization is a well-established organization (such as a large savings and loan association).

The independent auditor who plans to express an opinion on financial statements of an association should be satisfied regarding the adequacy of auditing procedures performed for loans serviced by others when such loans are significant to the financial statements.

Loans Serviced for Others. Although loans sold to others are not assets of the association, the auditor should be satisfied that they have been properly accounted for. This entails tests of compliance with the terms of applicable servicing agreements and confirmation with the owners. The audit procedures used are much the same as for loans that belong to the association.

The independent auditor should be familiar with the audit and reporting requirements of the Federal Home Loan Mortgage Corporation and other organizations for which an association is servicing loans.

Auditing Loan Accounts

Inspection of Documents

In testing the validity of loans, the extent of inspection of loan documents should be based on the independent auditor's evaluation of the association's internal accounting control. A test of the files supporting old loans (loans made before the period covered by the current audit), as well as new loans (including some of the loans still in process of disbursement),

is generally needed to evaluate the association's controls and procedures. All of the documents relating to a particular loan usually are filed together in a separate folder for that loan.

Depending on the particular loan account being considered, the test inspection of documents supporting loans usually should involve an examination of the applications, appraisal reports, notes, deeds of trust, mortgages or chattels, title insurance or legal opinion, insurance policies, settlement statements, regulation Z statements, flood insurance documentation, and VA guarantees or FHA insurance, if applicable. The existence and ownership of such documents in the hands of attorneys, escrow agents, or others should be confirmed, or the documents should be inspected. If documents are in the process of being recorded and therefore are not in the hands of the association or its attorneys, the independent auditor should be satisfied that proper documents are subsequently received by the association.

The inspection of documents also should include tests of approvals by the board of directors or loan committee, tests of evidence (such as stamped loan documents) that mortgage documents have been entered on the public record, comparison of loan amounts with appraisals, inspection of additional collateral indicated, and inspection of the adequacy of hazard and title coverage.

Associations, as trustees for the FHLB, are required to segregate and hold in separate files documents supporting loans pledged as collateral for advances from the FHLB. The auditor may be required to report on mortgage collateral verification audit procedures and results as prescribed by the regulations of the FHLB system. Loan documents for loans pledged against borrowings from other banks may be in the hands of the association or a bank; in either case, confirmation of the pledge should be obtained.

The independent auditor should not attempt to pass judgment on technical matters relating to loans, such as the value of collateral or the status of the title. The auditor should be satisfied, based on tests, that opinions of appropriate experts in such matters are on file. The auditor should consult with, or request the opinion of, appropriate independent appraisers or counsel for questions arising concerning values or titles. If the independent auditor concludes that an independent appraisal is necessary, he should be guided by SAS no. 11, *Using the Work of a Specialist*.

Subsidiary Ledgers

Trial balances of the detail loan ledgers should be obtained from the association and proved arithmetically or, if necessary, prepared by the independent auditor or prepared under the control of the independent auditor and reconciled with the general ledger control account. If they are prepared by the association, the auditor should compare the trial balances to the detail loan ledgers to the extent considered necessary. The reconciliation of subsidiary or detail ledgers may be performed by an association's employee working under the control of the independent auditor. Control should be maintained over the ledgers until the reconciliation is complete in order to prevent improper adjustment of the accounts. If internal accounting controls are satisfactory, the examination of loan accounts, including the balancing of loan ledgers, may be performed at a date other than the date of the statement of financial condition being audited. When detail procedures are performed at a date other than the date of the statement of financial condition, transactions between the audit date and financial statement date should be reviewed and tested. Procedures followed should be to determine that internal accounting controls are satisfactory during the intervening period.

Delinquent Loans

The "aged" list of delinquent loan balances should be tested for completeness and accuracy. Delinquent loans frequently are an indication of potential losses, exposure to which varies by type of loan. The independent auditor should consider such accounts, the association's collection procedures, loan modifications, and other pertinent data in evaluating the reasonableness of the allowance for losses, if any, provided by the association.

Entries for loans charged off should be reviewed to determine that approval was given by the board of directors or the loan committee.

Confirmation of Loans

In determining the amounts and loans to be confirmed, the auditor should bear in mind that confirmations only provide authentication of transactions and do not furnish assurance regarding collectibility. See page 12, "Confirmation Procedures."

Property Taxes, Assessments, and Insurance

Inquiries should be made concerning the association's practices for the payment of borrowers' property taxes, assessments, and insurance and the methods of determining whether the items are promptly paid and properly applied. The independent auditor should test the amounts provided by the borrower for taxes by referring to prior tax bills and current tax rates. See the section entitled "Advance Payments From Borrowers for Taxes and Insurance."

Accrued Interest Receivable on Loans

Associations may include accrued interest income in the related loan balances or in a separate account designated "accrued interest income." The independent auditor should be particularly attentive to the consistency of the method used to record interest income. If an association accounts for interest on the cash basis, the materiality of unrecorded accrued interest income in relation to the income statement and balance sheet should be considered. If the cash basis or modified cash basis is used, the independent auditor should be guided by the provisions of SAS no. 14, *Special Reports*.

Some associations schedule mortgage loan payments on the first day of the month, while others schedule monthly payments on other specified dates. Interest collected may be for the previous month or for the current month. The methods of recording interest for monthly amortization loans are not necessarily the same as methods used for other loans. Further variations may be found in regard to loans serviced by others, since some associations accrue interest that is expected from the servicer, while others record the interest only as received from the servicer.

When interest income is accrued, an allowance for uncollectible interest should be considered. The auditor should be aware of regulations that place limits on the accrual of delinquent interest. The accrual of interest income on delinquent loans should be discontinued when it is probable that the interest will not be received.

Interest income should be subjected to an overall arithmetical test or an arithmetical test of selected items. The overall test of interest income can be performed with relative ease if the association maintains controls for loans according to interest rates. In addition, the interest income accounts

should be subjected to an analytical review for the period and comparisons should be made with the preceding year. Unusual changes or fluctuations should be investigated.

Sales of Loans or Participations

Savings and loan associations sometimes sell loans or participations in loans. When entire loans are sold, the selling association may or may not continue to service the loans. When a participation in loans (that is, proportionate interest and sharing of risk in a loan or group of loans) is sold, the selling association frequently continues to service the loans. In either situation, the selling association may or may not be paid a servicing fee, normally expressed as a percentage of the principal balance of the loans outstanding. Ordinarily, servicing fee rates are set at rates currently prevalent in the industry; however, an association may occasionally sell loans at servicing fee rates significantly different from prevailing rates. The AICPA Accounting Standards Division (division) has issued Statement of Position 74-12, *Accounting Practices in the Mortgage Banking Industry*, which sets forth the recommended accounting treatment for loans sold at servicing fee rates significantly lower than prevailing rates. In this instance, the division concluded that an adjustment to sales price would be required whenever the impact on operating results was significant. Such adjustments would result in deferred credits to be written off into servicing fee income over future years. The FASB is currently considering the matter of accounting for servicing fees and has issued FASB Invitation to Comment, *Accounting for Certain Service Transactions*. Any pronouncement ultimately issued may be applicable to associations entering into the types of transactions described above.

Generally accepted accounting principles require that gain or loss be recognized at the time of sale of loans or participations. However, if at the end of any reporting period it is apparent that the association intends to sell certain loans and the anticipated sale will result in a loss, the association should establish an allowance for losses. The allowance for losses should be deducted from the related asset in the statement of financial condition. Gains and losses should not be deferred as new loan yield adjustments.

In accounting for sales of loans or participations, the objectives are to recognize in the year of sale the economic gain or loss from the transactions and to avoid including in the year of sale income or expense attributable to future periods.

When loans are sold outright and are not to be serviced by the selling association, the gain or loss is measured by the difference between the selling price and the face amount (less applicable deferred loan fees, if any) of the loans sold. If loans sold or loans included in a participation sold are to be serviced by the selling association, gain should be decreased or loss increased by the excess, if any, of estimated future servicing costs over estimated future servicing revenues, discounted to present value.

Because of the variety of arrangements under which participations are sold, it is important to consider the terms of sale, effective yield to the purchaser, and arrangements for servicing, in addition to the stated selling price. Premium or discount may result when a participation is sold at a price equal to the face amount of the loans included in the participation sale and the seller agrees to pay the purchaser a rate of interest greater or less than the stated rate of interest of such loans. In such cases the premium or discount should be represented by the difference between the future interest to be collected by the seller and the interest to be paid to the purchaser after considering future servicing revenues and costs, all discounted to present value.

The principles and guidelines set forth in Accounting Principles Board Opinion no. 21 apply with respect to determining the existence and amount of premiums and discounts, the method of amortization, and statement presentation.

If all of the terms and arrangements relating to the sale have the effect of producing a premium or discount to the seller, then this premium or discount should be deferred and amortized in such a manner as to result in a constant rate of interest when applied to the uncollected balance at the beginning of any period. Generally accepted accounting principles for premium or discount amortization conflict with the reporting requirements of the FHLBB. The treatment of differences in the reports filed with the FHLBB is discussed on page 7, "Timing of the Audit."

Undisbursed Portion of Mortgage Loans

Most associations carry one or more accounts labeled “loans in process” which represent the undisbursed portion of mortgage loans. Control accounts should be supported by subsidiary ledgers containing an individual account for the undisbursed portion of each mortgage loan. The aggregate of open balances in the subsidiary ledgers should be aged and balanced with the related control accounts. Debit balances (indicating overdrafts) and inactive accounts should be reviewed.

Since the principal amounts of the undisbursed portion of loans are recorded at the gross amount, confirmation requests for such loans should include both the total amount of the loan and the undisbursed balance at the date confirmation is requested.

Tests should also be made of documents in the association’s files that support disbursements charged to individual accounts, which in turn support the undisbursed portion of mortgage loans. The tests should include loans completed or closed out during the period covered by the audit.

The undisbursed portion of mortgage loans should be deducted from the related mortgage loans on the asset side of the statement of financial condition and the amount should be disclosed either on the face of the statement or in the notes to the financial statements. The regulatory reporting treatment for this item may conflict with generally accepted accounting principles, although results of such treatment in some instances may not differ materially from that obtained if generally accepted accounting principles were followed.

Loan Commitments

Loan commitments are not recorded in the accounts, but if the amounts of the commitments are significant in relation to the resources of the association, the total commitments should be disclosed in the notes to the financial statements.

Most associations maintain current files of outstanding loan commitments. The auditor should review them and make such tests as he considers necessary in the circumstances.

Accounting for Troubled Debt Restructurings

The provisions of FASB Statement no. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, should be applied by savings and loan associations in accounting for troubled debt restructurings consummated after December 31, 1977. Paragraph 2 of FASB Statement no. 15 contains the following definition of a troubled debt restructuring:

A restructuring of a debt constitutes a *troubled debt restructuring* for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.

A note to that paragraph states:

Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term *troubled debt restructuring* in this Statement.

Among other things, FASB Statement no. 15 requires assets, including real estate acquired in settlement of loans, to be valued at their fair value when the restructuring occurs. *Fair value* is defined as the amount a debtor can reasonably expect to receive in a current but not forced or liquidation sale from a willing buyer and should be measured by market value if an active market exists. If no active current market exists for the assets acquired but exists for similar assets, the selling price in the market for similar assets may be helpful

in estimating the fair value of the assets acquired. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved. If the association's investment in real estate acquired in settlement of loans exceeds its fair value, a write-down should be recognized either through a charge to the appropriate valuation allowance, assuming adequate provision for loss was previously made in establishing the allowance, or as a charge against current earnings.

Real estate acquired through a troubled debt restructuring should be accounted for the same as real estate purchased for cash. The fair value of the assets becomes the cost basis for accounting purposes. Periodically thereafter the real estate should be reevaluated and allowances for losses should be provided in accordance with the recommendations set forth in the section on "Accounting for Real Estate Acquired Other Than by Troubled Debt Restructurings." Notes receivable arising from sales of such real estate should be accounted for according to the provisions of APB Opinion no. 21, *Interest on Receivables and Payables*, so that the resulting receivable carries a market interest rate.

FASB Statement no. 15 requires that a modification of terms of a loan receivable be accounted for prospectively and not as a change in the recorded investment (see note 17 of FASB Statement no. 15) in the receivable unless total future cash payments as specified by the new terms are insufficient to liquidate the recorded investment. The excess of future cash receipts, including both receipts designated as interest and receipts designated as principal, specified by a modification over the recorded investment in the receivable should be recognized as interest income over the life of the restructured agreement. This interest income should be recorded in such a way that a constant level rate of interest is earned on the remaining balance of the recorded investment in the receivable. If such future cash receipts specified by the new terms are less than the recorded investment in the receivable, the recorded investment should be reduced to an amount equal to the future cash receipts specified. The amount of the reduction is a loss that should be recognized according to paragraph 35 of FASB Statement no. 15. Thereafter, all

cash receipts should be recorded as repayments of the restructured debt, and no interest income should be recognized. At the time of restructuring and periodically thereafter, the loan receivable should be evaluated and the allowance for losses should be provided in accordance with the recommendations set forth in the section on “Accounting for Loans and Receivables Collateralized by Real Estate Other Than Troubled Debt Restructurings.”

FASB Statement no. 15 requires legal fees and other direct costs incurred by a creditor to restructure troubled debt to be charged to expense when incurred. Costs to bring the real estate acquired to a rentable or salable condition, including those that exceed the estimate used in determining fair value at the date of restructuring, should be accounted for in accordance with the recommendations set forth in the section on “Accounting for Real Estate Acquired Other Than by Troubled Debt Restructurings.” Uncertainty of collection should be considered in accounting for allowances for losses on loans.

Effective for fiscal years ending after December 15, 1977, FASB Statement no. 15 requires creditors to disclose by major categories of receivables the total dollar amount of restructured troubled debt (regardless of when the restructuring occurred), the interest income that would have been recorded under the original terms of the debt for the accounting periods presented, the interest income that was recorded under the restructured terms, and commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructurings. Unless the amounts are material, these disclosures are not required for real estate loans secured by one- to four-family residential properties and loans to individuals for household, family and other personal expenditures (mobile home, education, and other consumer loans).

Accounting for Loans and Receivables Collateralized by Real Estate Other Than Troubled Debt Restructurings

Management is responsible for establishing policies affecting the evaluations of real estate loans. The association's

policies should be disclosed in the notes to the financial statements.

The independent auditor's examination should provide sufficient evidence supporting management's determination of the provisions and allowances for losses to support his opinion on the financial statements. In evaluating the adequacy of allowances for losses on loans, the independent auditor should consider delinquencies, evidence of the value of collateral, credit standing of the borrower, unusual economic conditions that may affect the collectibility of loans, the location and type of collateral, and all other relevant information.

The allowances for losses should be reevaluated each reporting period. In the discharge of this responsibility, management may use the services of association appraisers, independent appraisers, or others. The independent auditor should obtain an understanding of management policies and the application of generally accepted accounting principles in determining the reasonableness of provisions and allowances for losses.

The allowance for losses on a large portfolio of loans secured by single-family residences or multiple housing with relatively few units may be determined and evaluated statistically based on the volume of loans made, loans outstanding, and historical loss experience. Large loans for other residential housing, commercial property, land, or properties under development should be reviewed individually.

Allowances for losses on doubtful or troubled loans should be based on estimated net realizable value, as discussed in the subsequent section, unless it is probable, in accordance with FASB Statement no. 5, *Accounting for Contingencies*, that loans will be foreclosed; in which case, allowance for losses should be based on fair value as defined in FASB Statement no. 15.

Federal regulatory requirements do not allow charging certain losses directly to general reserves. However, some states still permit that practice, and some associations continue to charge such losses to general reserves although the practice is no longer condoned by federal regulatory authorities. Under generally accepted accounting principles, losses not previously provided for or additions to the provision for losses must be charged to expense in the statement of opera-

tions. In the preparation of financial statements, losses that have been charged directly to general reserves on the books of the association should be reclassified as a charge against earnings.

Generally accepted accounting principles for real estate losses may conflict with reporting requirements of the FHLBB. The treatment of the differences in the reports filed with the FHLBB is discussed in the section entitled "Timing of the Audit."

Loss allowances accumulated through charges in arriving at net income should be deducted from the related assets in the statement of financial condition. Furthermore, it may be appropriate to disclose in a note to the financial statements an analysis of the activity in the loss allowance account.

Accounting for Real Estate Acquired Other Than by Troubled Debt Restructurings

Real estate purchased for sale or development and real estate not subjected to FASB Statement no. 15 (see paragraph 7) should be carried at the lower of cost or estimated net realizable value. Direct holding costs should be capitalized. However, carrying amounts should not exceed estimated net realizable value. *Estimated net realizable value* means the estimated sales price in cash or cash equivalent upon subsequent disposition reduced by the sum of the following estimates: (1) direct selling expenses such as sales commissions, advertising cost of title policy, and other expenses of disposition, (2) costs of completion or improvement, and (3) direct holding costs including taxes, maintenance, insurance (net of rental or other income), and cost of all capital (debt and equity) during the period to be held. The FASB has recently issued an exposure draft of a proposed statement of financial accounting standards, *Capitalization of Interest Costs*, and any pronouncement ultimately issued is expected to be applicable to associations. Some of the important factors usually involved in determining estimated net realizable values of loans and real estate for savings and loan associations are discussed below:

1. *Estimated sales price.* Usually this price is determined
(a) by reference to comparable sales for cash or cash

equivalents of individual units in the same development at approximately the same time, (b) by current offering price, (c) by reference to appraisals, or (d) by a combination of those approaches.

2. *Projected date of disposition.* The date of disposition is within the control of management and may be extended or shortened to recognize their anticipation of the future condition of the real estate market or to recognize the need to improve or to complete construction of a project.
3. *Estimated costs of disposition.*
4. *Estimated costs of improvements or completion.* These costs are typically involved in the disposition of unimproved or partially improved property and of property needing rehabilitation.
5. *Estimated direct holding costs.* In determining estimated net realizable value, the estimated future sales price should be reduced by a provision for the average cost of all capital (debt and equity), taxes, maintenance, and other direct holding costs during the period to be held.

The management of an association is responsible for evaluating all relevant factors and for determining the carrying amount of real estate acquired and an allowance for losses. Although such investments are often immaterial in relation to total assets, the effect of possible losses, if any, may be significant in relation to operations or net worth.

Capitalizing direct holding costs invested in the property for financial reporting purposes but charging them to expense for tax purposes is a timing difference that should be accounted for in conformity with the provisions of APB Opinion no. 11, *Accounting for Income Taxes*.

Gains and Losses on Sales of Real Estate

Gains on the sale of real estate are generally recorded on the books of associations in compliance with supervisory requirements that may change from time to time. Present federal supervisory regulations provide that when loans are made to facilitate sales of real estate owned or a contract of sale is entered into, profits on the sales of such real estate not

realized in cash must be deferred and recorded as income only to the extent that cash is received on the principal.

In accounting for sales of real estate, savings and loan associations should follow the applicable requirements of APB Opinion no. 21, *Interest on Receivables and Payables*; AICPA Industry Accounting Guides, *Accounting for Profit Recognition on Sales of Real Estate* and *Accounting for Retail Land Sales*; Statement of Position no. 75-6, *Questions Concerning Profit Recognition on Sales of Real Estate*; and Statement of Position no. 78-2, *Accounting Practices of Real Estate Investment Trusts*. The present regulatory method of recognizing gains differs from methods prescribed in those pronouncements. The two industry accounting guides note that real estate transactions usually create receivables that are collectible over an extended period of time and that in exceptional cases, because of the terms of the transactions or other conditions, no reasonable basis can be established for estimating the degree of collectibility of receivables. When such circumstances exist, and as long as they exist, either the installment, the cost recovery, or the deposit method of accounting, whichever is applicable in the circumstances, should be used.

The auditor should review the method followed by the association in recording gains on sales of real estate for conformity with generally accepted accounting principles. Tests should be made of the computation of amounts carried as deferred credits and of amounts recorded as income during the period.

Audit Procedures for Real Estate

The auditor is responsible for evaluating management's determination of both the carrying amount of real estate and the adequacy of the allowance for losses, if any. In this connection, the auditor should be alert for uncertainties concerning the carrying amount of real estate that may be so great as to require him to modify his report.

It may be appropriate for the independent auditor to test-inspect properties, observing, for example, the overall stage of completion of construction projects or the overall deterioration of completed properties held for sale, rented or not.

However, the auditor should not attempt to appraise property. The auditor may sometimes need to seek corroboration by an independent appraiser, but other times he may be satisfied with data furnished him. If the independent auditor concludes that he needs the help of an independent appraiser, he should be guided by SAS no. 11, *Using the Work of a Specialist*.

Appraisals are a factor in determining the net carrying amount of real estate and in establishing the value of collateral on loans. Appraisals by the association or by independent appraisers may be considered acceptable audit evidence. Appraisals are the products of work by people trained in appraisal principles and techniques. The quality of appraisals may vary, however, and in some instances the auditor may have reason to believe certain appraisals are unrealistic. The auditor may often be able to compare a particular appraisal with an appraisal of the same property required by a state or federal regulatory body or may have independent appraisals made of specific properties. Appraisals can be made on different bases. The independent auditor should understand and consider the bases of the appraised value and the factors used in arriving at such values.

Real Estate Sold on Contract

An association may sell real estate with little or no initial payment required from the buyer or may sell to buyers who may not qualify for a conventional association loan because of credit or other reasons. Since the risk of default by those purchasers may be relatively greater, documents are generally prepared in a manner that will permit the easiest reacquisition of the property by the association if a default occurs. Real estate sold on contract has most of the attributes of a conventional loan secured by real estate except that the association retains legal title to the real estate and conveys title to the purchaser only when the amount due under the contract has been paid. The provisions of AICPA Industry Accounting Guides, *Accounting for Profit Recognition on Sales of Real Estate* and *Accounting for Retail Land Sales*, Statement of Position no. 75-6, and APB Opinion no. 21 all apply to real estate sold on contract.

The audit procedures should be similar to those for mortgage loans, including reference to the authorization of the

board of directors, inspection of documents, determination that title to the real estate is retained by the association, confirmation of balances, review of collectibility, and value of collateral. The auditor should be aware that more than normal credit risk usually is present in this type of lending arrangement.

If large or unusual contracts of sale are involved, the auditor should consider field inspection to ascertain whether the properties show obvious signs of deterioration. If so, the independent auditor should consider the possible need for an appraisal of the property, which may result in a provision for loan losses.

Reference should be made to the section entitled “Deferred Income,” for discussion of the supervisory regulations on profit on real estate sold.

Investments in Real Estate Ventures

The AICPA Accounting Standards Division has issued Statement of Position no. 78-9, *Accounting for Investments in Real Estate Ventures*. This statement recommends appropriate accounting and reporting practices for associations with real estate venture arrangements.

Investments in Service Corporations

A number of savings and loan associations have equity investments in subsidiary companies generally described as service corporations. The amount of investment in service corporations and the nature of the activities in which service corporations are permitted to engage are governed by federal rules and regulations or by state law. The independent auditor should be familiar with the rules and regulations relating to investments in and activities of service corporations to the extent that noncompliance might materially affect the financial statements being examined.

An association having an investment in one or more subsidiary service corporations must file a report containing consolidated financial statements with the district director—examinations of the appropriate FHLBB district. Separate reports may also be required for each entity in the consolidated group. The report containing consolidated financial

statements must include, either by note or in a schedule, the balance sheets and statements of income for the association and each of its service corporations included in the consolidation. If separate audit reports are issued, a copy of each must be filed with the district director—examinations of the appropriate FHLBB district.

If consolidated financial statements are clearly inappropriate (according to criteria provided in Accounting Research Bulletin no. 51), the equity method should be used in accounting for investments in unconsolidated subsidiaries as set forth in APB Opinion no. 18, *The Equity Method of Accounting for Investments in Common Stock*.

Office Buildings, Equipment, and Leasehold Improvements

The audit procedures for office buildings, equipment, and leasehold improvements should be the same as those customarily followed in the audit of other commercial and industrial enterprises and should include, as appropriate, the examination of documents in support of major additions and sales or retirements during the period under examination. Deeds and title insurance policies should be examined in support of major real property acquisitions. Evidence of insurance coverage should be obtained and reviewed in the light of present values and co-insurance clauses in the policies.

The association's policies for capitalization, depreciation, repairs and maintenance and obsolescence, and conformity of those policies with generally accepted accounting principles and their consistent application should be investigated. The association's calculations of depreciation expense for the year should be checked or appropriate tests should be made, and the total should be reconciled with charges to the association's operating accounts.

Appropriate information should be obtained for the total cost of a major expansion program and for the amount of related commitments. Commitments should be disclosed in the notes to the financial statements if amounts are material.

The auditor should determine compliance with federal and state regulatory requirements and restrictions concerning an association's investment in or lease of office properties.

If association premises are leased from others, the leases should be examined. Pertinent lease information should be recorded in the work papers to support lease disclosures in the financial statements. FASB Statement no. 13 sets forth the principles applicable to accounting for leases, including criteria for determining leases that should be classified as capital leases.

Safe Deposit Box Operations

The procedures used by the association in operating safety deposit vaults should be reviewed. Insurance policies covering liabilities that might be incurred in the operation of these vaults should be reviewed for compliance with applicable laws and regulations.

Deferred Charges and Prepaid Expenses

Deferred charges and prepaid expenses usually consist of prepaid FSLIC insurance premiums, other prepaid insurance, prepaid property taxes, and prepayments into the secondary insurance reserve of the FSLIC.

Prepaid insurance premiums to the secondary reserve are the total of such payments made since 1961, as required by law, plus income earned on the payments by the FSLIC and added to the association's account, less the amounts used to pay the regular annual FSLIC insurance premiums and refunded to the association.

The association's prepayments into the secondary insurance reserve, together with those of all other insured associations, constitute a secondary reserve of the FSLIC for possible industry-wide losses of the FSLIC, incident to its insurance of accounts. The FSLIC also maintains a primary reserve, which must be depleted before the secondary reserve is charged with such losses. Public Law 93-101, 87 Stat. 342 dated August 16, 1973, provides for liquidation of the secondary reserve over a period of ten years beginning in 1974. An association's pro rata share will be refunded over the ten years. The cumulative amount of the prepayments should be confirmed directly with the FSLIC, and the independent auditor should determine that the association's payments comply with existing regulations.

Audit procedures for other deferred charges and prepaid assets should be comparable to those in the audits of other commercial and industrial enterprises. The procedures include a review of insurance policies and tax bills and analysis of the data to determine that deferral of charges to future periods is appropriate. The procedures also should include a review of applicable expense accounts to ascertain that they do not include material amounts properly deferrable to future periods.

Other Assets

The independent auditor should examine appropriate evidence supporting the carrying amount of other assets and should send confirmation requests as appropriate.

Some associations provide memorandum control accounts for their supplies of unissued travelers checks, money orders, and savings bonds. Such items should be counted and reconciled to control accounts at the time of the cash count and confirmation obtained regarding the association's accountability.

Savings Accounts

Savings accounts are the principal source of funds of savings and loan associations. Passbook savings accounts historically have been the predominant form of savings accounts; however, in recent years there has been a substantial increase in the use of a variety of savings certificates. Passbooks are generally issued to savers; additions, withdrawals, and interest payments are entered in the passbooks by the association. However, some associations furnish periodic statements of transactions in place of furnishing passbooks. Certificates are issued in various forms with varying maturities and interest rates as permitted by the rules and regulations governing associations. Associations often provide other special purpose accounts such as periodic savings accounts, which are paid to the saver at the end of specific terms. Examples of these would include Christmas Club accounts and investment club accounts. Interest rates on savings accounts are governed by regulation "Q" of the board of governors of the Federal

Reserve System. Regulations that affect insured savings and loan associations are incorporated in the rules and regulations of the FHLB system.

Disclosure should be made in the notes to financial statements of the composition of savings accounts by interest rates.

Before beginning the examination of these accounts, the independent auditor should become acquainted with the rules and regulations of the supervisory authorities and with the association's established policies and procedures pertaining to savings accounts. Furthermore, because of the volume of transactions and the significance of savings accounts in relation to the statement of financial condition, the independent auditor should give particular attention to both the internal accounting control relating to these accounts and the accounting methods for recording transactions.

Individual records are maintained for each saver. These records may be in the form of individual ledger cards, but most records are maintained on electronic data processing equipment operated by the association or a service bureau. Each account is assigned a number and, in addition to general ledger control accounts for the various classifications of savings, subcontrol accounts are usually maintained for numerical or alphabetical groups within each major classification. Signature cards are usually filed alphabetically to facilitate cross-referencing.

Generally, a savings transaction is initially recorded by the teller posting machines, which simultaneously make an entry in association records and on a customer's passbook, if one is used. Several methods are used, however, to record the transaction on the customer's individual record maintained by the association. Many associations have installed "on line" window posting machines which permit immediate entry of transactions into electronic data processing records. If the association maintains individual savings ledger cards, the cards and entries in the customers' passbooks may be posted simultaneously with the recording of transactions in the posting machine. A variation of this method, known as "back office posting," permits an association to post savings cards at a later time using the primary documents (deposit slips and withdrawal slips) as the bases for the entries.

Subsidiary Ledgers

Trial balances of the detail savings account ledgers should be obtained from the association and proved arithmetically or, if necessary, prepared by or under the control of the independent auditor and reconciled with the general ledger control account. If prepared by the association, the trial balances should be test-checked to the detail savings account ledgers. Subsidiary or detail ledgers may be reconciled by the association's staff working under the control of the independent auditor. Adequate control must be maintained over the ledgers until the reconciliation is completed to prevent improper adjustment of the accounts. If internal accounting controls are satisfactory, the savings accounts may be examined and ledgers balanced at a date other than the date of the statement of financial condition being audited. If detail procedures are performed at a date other than the date of the statement of financial condition, transactions between the audit date and financial statement date should be reviewed and tested. The procedures performed should include those necessary to determine that internal accounting controls are functioning during the intervening period.

Confirmation of Savings Accounts

Confirmation of a selection of savings account balances (including certificate and bonus savings accounts) should be requested from savers. Confirmation requests generally should be prepared as of the date selected for performing other auditing procedures for subsidiary ledgers. They ordinarily should include a representative sample of active and inactive (dormant) accounts, accounts closed during the audit period, and large and unusual accounts. A general discussion of confirmation procedures appears on page 12.

Investment Certificates

Tests should be made of investment certificate records and of cancelled certificates for the shares withdrawn during the audit period.

Bonus Accounts

An association may have bonus savings accounts with interest rates above the rate on its regular accounts if certain conditions are met by the saver. Tests should be made to ascertain that the specified conditions are met and that the association is accruing interest at the bonus rate.

Certain long-term savings accounts have interest rates higher than those paid on regular passbook savings. The account holders, however, are only entitled to the higher rate of interest by holding the accounts to their maturity. Some of the accounts also provide for an “interest penalty” if there is an early withdrawal. The accounting for the interest penalty is not consistently applied throughout the industry. The interest penalty is sometimes recorded as income and sometimes as a reduction of interest expense. The penalty should be reported as a reduction of interest expense in the period that the penalty is assessed.

Safekeeping for Members

If an association holds issued certificates and savings passbooks in safekeeping for members, the independent auditor should perform such tests and confirmations as may be necessary in the circumstances giving due weight to the effectiveness of internal accounting control procedures.

Pledged Savings Accounts

Savings accounts pledged as collateral for loans on savings accounts or as additional collateral for mortgage loans generally remain in the regular savings accounts control. Accounts pledged should be appropriately designated and withdrawals restricted.

Other

Additional tests may include (but need not be limited to) review of the control over origination of, and access to, signature cards, tests of daily withdrawal slips in relation to disbursement totals, the comparison of the withdrawal slips

to the applicable subsidiary record and signature cards, review of the control over origination and access to mailing address files, review of the control of mail receipts, and tests to detect suppressed accounts.

Internal accounting control over savings accounts is somewhat enhanced by the fact that the savers may be aware of discrepancies in their account balances through their pass-books or statements received from the association. In cases in which savings accounts contain no activity (dormant accounts) or in the case of some long-term savings certificates upon which interest is not paid on a current basis or for which statements are not mailed, this control feature is not present. Accordingly, associations may adopt alternative control procedures over such accounts, such as verification of activity. The auditor should be familiar with association policies and procedures and should consider them in performing compliance and other audit tests.

The section of this guide entitled “Interest on Savings Accounts” discusses interest paid on savings accounts.

Advances From Federal Home Loan Bank and Other Borrowed Money

Members of the FHLB system are permitted to borrow funds from the FHLB for expansion (funds to meet increased demand for loans) or for withdrawals (funds to meet withdrawals by savings account holders). These advances may be either short-term or long-term. The borrowing member’s FHLB stock is pledged against all advances and, generally, a portion of the association’s loan portfolio is also pledged. It is also possible that other assets may be pledged.

Secured or unsecured borrowings may also be obtained from sources other than the FHLB on either a secured or an unsecured basis.

The legal limitations on borrowings from the FHLB and other sources are detailed in the *Rules and Regulations for Insurance of Accounts*. The full borrowing power prescribed by those regulations is not normally available to an association because available credit lines usually are determined by administrative policy pronouncements from the FHLBB. Furthermore, the various FHLBs may control the credit lines of member associations on a case-by-case basis.

On loans pledged as collateral to the FHLB, the association normally retains possession of the loan documents under a trust agreement with the FHLB. The FHLB frequently requests that the independent auditor report to it that he has performed specific tests related to the pledged loans. Confirmation of the terms, amounts of borrowings, and related collateral should be obtained from the lender. It should be noted that the interest rate on borrowings from the FHLB may not be in agreement with the rate stated in the loan agreement because of rate adjustments by the FHLB.

Due Federal Reserve Bank for Savings Bonds Sold

The liability to the Federal Reserve Banks (FRB) for series E bonds sold should be compared with the inventory and remittance reports submitted to the FRB and differences should be explained. This should be done at the time the unissued and redeemed bonds on hand are counted in conjunction with the cash count, as discussed previously. (See the sections entitled “Confirmation Procedures” and “Other Assets,” of this guide.)

Advance Payments From Borrowers for Taxes and Insurance

Many associations require borrowers to make monthly payments in addition to principal and interest in order to accumulate funds from which the association can pay property taxes and insurance premiums. The balances of these accounts are often referred to as “escrow accounts” or “impounds.”

Trial balances of the detail ledgers should be prepared by the independent auditor or obtained from the association, proved arithmetically, and reconciled with the general ledger control account. If prepared by the association, the trial balances should be test-checked to the detail ledgers.

Confirmation of the escrow balances should be requested in conjunction with the confirmation of borrowers’ loan balances. It may be necessary to furnish borrowers with the amounts paid by the association for insurance and taxes as shown by receipted invoices and tax bills. Compliance with any special legal requirements under contracts or statutes (such as for segregating the related cash or establishing trust

funds) should be tested and the special funds and related liability separately identified in the association's balance sheet or disclosed in a note to the financial statements.

Unapplied Loan Collections

Under some systems, collections received on loans are credited to unapplied loan collections until the proper allocation is determined. The independent auditor should review this account to ascertain that it is being properly maintained and, if material, the amounts should be reclassified for financial statement purposes.

Income and Franchise Taxes Payable

In addition to the tax law applicable to corporations generally, special provisions are provided in subchapter H of the Internal Revenue Code for savings and loan associations, provided an association meets certain definitional requirements contained in the code. The most significant provision deals with the allowable bad debt reserve addition and provides generally for a deduction in an amount equal to a percentage of taxable income, subject to certain limitations and requirements. This annual deduction permitted by the code generally differs significantly from the bad debt experience on which determination of pretax accounting income is based. Another significant provision treats real property acquired in settlement of loans as having the same character as the loan it secured. Accordingly, foreclosure is not a taxable event and the property has the same tax basis as that of the related loan. For tax purposes, provisions for estimated losses on loans and property acquired in settlement of loans and any gains or losses on sales of such property are not included in the determination of taxable income but are charged or credited, as appropriate, to the accumulated bad debt reserves. Savings and loan associations typically report operations on the cash basis for tax purposes but maintain their books and report to regulatory agencies and shareholders on the accrual basis.

Tax allocation required under APB opinions, including APB Opinion no. 11, applies to savings and loan associations. The APB determined in Opinion no. 23 that tax allocation for

savings and loan associations is not required for the “difference between taxable income and pretax accounting income attributable to a bad debt reserve. . . .” Under those opinions, the income tax provision should be based on income used for financial reporting, adjusted to treat the provisions for estimated losses on loans and property acquired in settlement of loans and gains or losses on sales of such property in accordance with the Internal Revenue Code.

In determining the amount on which tax allocation is not required, paragraph 21 of APB Opinion no. 23 defines certain terms:

The term pretax accounting income, as used in this section, represents income or loss for a period, exclusive of related income tax expense, determined in conformity with generally accepted accounting principles. The term taxable income, as used in this section, represents pretax accounting income (a) adjusted for reversal of provisions for estimated losses on loans and property acquired in settlement of loans, and gains or losses on the sales of such property, and adjusted for permanent differences, and (b) after giving effect to the bad debt deduction allowable by the United States Internal Revenue Code assuming the applicable tax return were to be prepared based on such adjusted pretax accounting income.

Paragraph 23 contains the following conclusion:

The Board concludes that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserves and undivided profits of a savings and loan association may not reverse until indefinite future periods or may never reverse. The association controls the events that create the tax consequence, and the association is required to take specific action before the initial difference reverses. Therefore, a savings and loan association should not provide income taxes on this difference. However, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction should be accrued as tax expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

The independent auditor should review computations of income and franchise tax accruals and should be familiar with

the specific provisions of federal, state, and local revenue laws and regulations affecting savings and loan associations.

The auditor's review should include the following steps:

1. Ascertain whether the association complies with the definitional requirements of the Internal Revenue Code to qualify for the specialized tax treatment accorded a savings and loan association.
2. Ascertain whether the amounts of permanent differences, including provision for estimated losses on loans and property acquired in settlement of loans and gains or losses on the sales of such property have been determined properly.
3. Ascertain whether the bad debt deduction has been computed properly by multiplying the current percentage provided in the Internal Revenue Code by the adjusted pretax accounting income (as defined in paragraph 21 of APB Opinion no. 23).
4. Ascertain that the bad debt deduction so computed does not exceed either the current 6 percent limitation, which is based on loans outstanding at the end of the year, or the current 12 percent limitation, which is based on year-end aggregate savings account balances. For this purpose, the accumulated balance of the bad debt reserves should have been calculated as if all tax returns for the association were prepared based on adjusted pretax accounting income.
5. Ascertain whether provision has been made for adjustments resulting from examinations of tax returns by taxing authorities.
6. Review the segregation of income tax expense between current and deferred income taxes.

Application of Paragraph 21 of APB Opinion No. 23

The application of paragraph 21 of APB Opinion no. 23 is illustrated below. The column "Federal Income Tax Return" is presented to illustrate the difference, resulting from timing differences, between the bad debt deduction computed under the provisions of APB Opinion no. 23 and the deduction allowable on the federal income tax return.

Reconciliation of "Pretax Accounting Income" to "Taxable Income"

	<u>Financial Statements</u>	<u>Federal Income Tax Return</u>
Income per financial statements, before income taxes (pretax accounting income)	\$800,000	\$800,000
Adjustments		
Provision for losses on loans and property acquired in settlement of loans	60,000	60,000
Gain on sale of property acquired in settlement of loans	(25,000)	(25,000)
Other permanent differences		
Officers' life insurance premiums	3,000	3,000
Municipal bond interest	(35,000)	(35,000)
Unallowable deductions	2,000	2,000
Dividends on pre-1942 FHLB stock	(1,000)	(1,000)
Timing differences		
Accelerated depreciation	—	(25,000)
Loan fees	—	75,000
Adjusted pretax accounting income		
Taxable income before bad debt deduction	804,000	854,000
Bad debt deduction (using 42% for 1977)	<u>337,680</u>	<u>358,680</u>
Taxable income	<u>\$466,320</u>	
Taxable income per federal income tax return		<u>\$495,320</u>
Tax thereon (assumed 50% rate and use of "net change" basis)	<u>\$233,160</u>	<u>\$247,660</u>

Under paragraph 23 of APB Opinion no. 23 the association would not be required to provide income taxes on the difference of \$337,680 between "taxable income" and "adjusted pretax accounting income." In this illustration, the current year's tax provision would be \$233,160 of which \$247,660 would be currently payable and the difference of \$14,500 relating to timing differences, deferred either as a prepaid tax or reduction of deferred taxes previously provided.

If, in the above example, the cumulative bad debt reserve balance on "qualifying real property loans" (QLR), as defined by the Internal Revenue Code, was such that the \$337,680 bad debt deduction would cause the balance of the reserve to exceed the 6% limitation based on total qualifying real property loans outstanding at year end, then "taxable income" would be computed as shown, following.

	<i>Financial Statements</i>	<i>Federal Income Tax Return</i>
Adjusted pretax accounting income (from above)	\$804,000	
Taxable income before bad debt deduction (from above)		\$854,000
Qualifying Real Property loans at year end		
6% thereof	<u>\$41,580,000</u>	<u>\$41,580,000</u>
Cumulative balance of QLR (the difference between the balance for book and tax purposes represents the cumulative effect of prior timing differences)	2,494,800	2,494,800
Adjustments (from above)		
Provision for losses on loans and property acquired in settlement of loans	\$2,385,800	\$2,000,000
Gain on sale of property acquired in settlement of qualifying real property loans (net)	(60,000)	(60,000)
	25,000	25,000

Adjusted balance of QLR	<u>2,350,800</u>	<u>1,965,000</u>
Bad debt deduction 42% of adjusted pretax accounting income (taxable income before bad debt deduction for federal income tax return), limited to the amount that increases the adjusted balance of QLR to 6% of qualifying real property loans at year end	<u>144,000</u>	<u>358,680</u>
Taxable income	<u>\$660,000</u>	
Taxable income per federal income tax return		<u>\$495,320</u>
Tax (assumed 50% rate and use of "net change" bases)	<u>\$330,000</u>	<u>\$247,660</u>

In this illustration under paragraph 23, the association would not be required to provide income taxes on the \$144,000 difference. The current year's tax provision would be \$330,000, of which \$247,660 would be currently payable and the balance of \$82,340, which relates to (1) the tax effect of timing differences and (2) reaching the 6 percent limitation on the bad debt reserve on the financial statement basis before reaching the limitation on the tax return basis, would be deferred.

General Reserve Appropriations and Disclosure

Paragraphs 24 and 25 of APB Opinion no. 23 state the following:

24. *Disclosure.* Information that should be disclosed in notes to financial statements of a savings and loan association concerning bad debt reserves that are accounted for as part of the general reserves and undivided profits includes:

- a. The purposes for which the reserves are provided under the applicable rules and regulations and the fact that income taxes may be payable if the reserves are used for other purposes, and
- b. The accumulated amount of the reserves for which income taxes have not been accrued.

25. The disclosure requirements set forth in paragraph 24 also apply to a parent company of a savings and loan association accounting for that investment either through consolidation or by the equity method.

The disclosure requirements and recommendations of APB Opinion no. 11, particularly paragraphs 60 and 63, are appropriate for fair presentation of financial statements in conformity with generally accepted accounting principles. Disclosures under APB Opinion no. 11 may include the following:

1. The reasons for, and amounts of, tax effects of the various types of timing differences.
2. Differences between the effective income tax rate indicated in the statement of operations and the statutory federal income tax rate.

Savings and loan associations frequently are members of affiliated groups of corporations, which sometimes are composed of a holding company, the association, and subsidiaries of either or both, and sometimes consist only of the association and its subsidiaries. If a savings and loan association joins with its affiliates in filing a consolidated federal income tax return, it is necessary to allocate the consolidated income tax liability among the affiliated companies. If a savings and loan association is a member of a group that presents consolidated

financial statements, the separate financial statements of each member require a determination of a provision for income taxes. The determination may be complex, particularly if one or more members of the group have a net operating loss deduction or available investment tax credits or foreign tax credits.

Several methods of tax allocation are followed in preparing separate financial statements for individual members of a consolidated group. The methods include allocating the tax based on the income or tax attributable to the association, as compared to the total income or tax of the group, or on the basis of the hypothetical tax liability that would have been incurred had the members filed separate income tax returns.

A problem in income tax allocation may arise if, for tax planning reasons, it is anticipated that the savings and loan association may forego its statutory bad debt deduction due to the availability in the consolidated return of operating losses or tax credits. Then arises the question of the manner in which the separate tax provision should be computed for the association. One view is that the separate tax provision for the association should be computed as if the maximum allowable bad debt deduction permitted under the tax laws is claimed. A second view is that the tax provision should not reflect a bad debt deduction that is not claimed in the consolidated income tax return. Both methods are currently used in practice and are considered acceptable.

The subject of intercorporate income tax allocation is currently under consideration by the AICPA's accounting standards executive committee.

Issuance of Mortgage-Backed Securities

Subject to limitations and eligibility requirements, associations may issue bonds collateralized by pools of whole real estate loans (mortgage-backed bonds). If the amount of mortgage-backed bonds is material, they should be shown separately on the statement of financial condition and all significant terms (for example, collateral amount, interest rate, repayment terms) should be disclosed in a note to the financial statements.

Debentures and Subordinated Debt

Federal regulations now permit the issuance of subordinated debt securities for terms of not less than seven years. Subordinated debt securities issued by savings and loan associations should be classified as debt on the association's statement of financial condition. Even though the securities may be wholly or partially considered as "net worth" for certain regulatory purposes, they are debt instruments that require repayment.

Other Liabilities

The accounts classified as other liabilities comprise accrued expenses and other items not specifically included in the liability accounts previously discussed. The audit procedures are similar to those followed in audits of other commercial and industrial enterprises.

Deferred Income

In compliance with regulatory requirements, certain income items are deferred and amortized over future periods. The independent auditor should be alert to the possibility that deferred income accounts, established to conform to regulations of the FHLBB, may conflict with generally accepted accounting principles. If deferral methods conflict with pronouncements of authoritative accounting bodies and have a material effect on the financial statements, appropriate adjustments should be made in the financial statements; otherwise, the auditor should modify his report.

Some of the items deferred under present supervisory regulations are the following:

1. *Unrealized profit on real estate sold.* Federal regulations require that profit on the sale that is not received in cash shall be deferred and recorded as income when principal payments are received. (See the section entitled "Gains and Losses on Sale of Real Estate" of this guide.)

2. *Gains or losses on security transactions.* Federal regulations provide that, as an alternative to recognizing such gains and losses when realized, an association could, during 1970 and 1971, elect to defer and amortize over a period not to exceed ten years all gains and losses (net of related taxes) resulting from the disposition of any securities if the disposition is part of a plan adopted to meet liquidity requirements and is consistently followed for all such transactions. (See the section entitled "Investments in Securities.")
3. *Interest earned but uncollected.* Associations may charge accrued interest to loan accounts, but some regulatory authorities require deferral of a portion or all of the accrued and uncollected interest.
4. *Unearned loan fees and loan fees collected in advance.* Unearned loan fees and fees collected in advance are loan fees in excess of those that may be taken directly into income as permitted by the FSLIC regulations. (See the section entitled "Loan Commitment Fees" and "Fees for Originating Loans in House.")
5. *Unearned discounts on purchased loans.* Present federal regulations require that unearned discounts on purchased loans be deferred and amortized over not less than ten years.
6. *Unearned discount on home improvement and consumer loans.* Interest is usually added to the principal of a home improvement or consumer loan and is amortized over the life of the loan.

The regulatory accounting treatment described for the items above may conflict with generally accepted accounting principles, although results of the treatment may sometimes not be materially different from that obtained if generally accepted accounting principles were followed.

Unearned discounts on purchased loans and unearned interest and finance charges included in the face amount of loans should be amortized on the interest method over the expected term of the related loans. The unamortized balance

should be shown separately and deducted from the related loans in the statement of financial condition.

Interest on loans is sometimes paid in advance by the borrower or may be deducted by the association from loan proceeds. The amounts should be deferred and reported as income when the interest is earned.

Accounting for home improvement and consumer loans should follow requirements in the AICPA Industry Audit Guide, *Audits of Finance Companies*.

The computation of amounts deferred and amounts recorded as income during the period should be tested. The auditor should consider whether any class or item of recorded income should be deferred.

Capital Stock

A number of states provide for capital stock associations, associations that are authorized by state charter to issue and sell capital stock (called permanent reserve shares, guaranty stock, or guarantee stock) to investors.

The auditing procedures for capital stock issued by a savings and loan association are generally the same as for other corporations.

Some capital stock associations may from time to time issue stock dividends to their investors. Unless the stock is closely held, generally accepted accounting principles require that stock dividends be recorded at fair market value in compliance with Accounting Research Bulletin no. 43, chapter 7, section B. However, state supervisory authorities may prohibit recognizing any amount on the books in excess of par value or the book value of the stock at the time issued. When a prohibition materially affects the presentation of the financial position of the association, the auditor should consider modifying his report.

Retained Earnings

Retained earnings should be shown as a single item on the statement of financial condition. If appropriate or required, a regulatory reserve account analysis can be presented in the

statement of retained earnings or stockholders' equity. The financial statements should disclose significant restrictions on the use of retained earnings for the payment of dividends and interest. The restrictions include absolute restrictions, such as those imposed by regulatory reserve requirements, state laws or credit agreements, and restrictions resulting from the accumulation of untaxed bad debt deductions for federal or state income tax purposes. A notation should be made beside the retained earnings account on the statement of financial condition indicating that the retained earnings are "substantially restricted."

General Reserves

The term "general reserves" refers to the statutory reserves established by an association for the sole purpose of providing an account against which to charge losses, but does not include valuation allowances. Usually the general reserves have been established by appropriation of retained earnings; however, they may be created by placing restrictions on other net worth accounts such as capital stock or paid-in capital. Additions are made in accordance with rules and regulations of federal and state supervisory authorities. General reserves may encompass one or more accounts of an association, usually described as follows:

- General reserve
- Federal insurance reserve
- Reserve for contingencies
- Legal reserve
- Reserve for bad debts

While general reserves are, in accordance with supervisory rules and regulations, provided to "absorb losses," they comprise a part of the equity or net worth of an association and accordingly should not be substituted for valuation allowances. Valuation allowances, if required, must be deducted from the specific assets to which they apply and should not be confused with general reserves. The term "general reserves" as discussed in this guide refers to appropriations of retained earnings and not to reserves for general

or unspecified business risks as discussed in paragraph 14 of FASB Statement no. 5. The accounting and disclosure requirements are discussed in paragraph 15 of FASB Statement no. 5.

Supervisory Reserves

All associations insured by the FSLIC must maintain a federal insurance reserve or other optionally named reserves for the sole purpose of providing an account against which to charge losses, in accordance with *Rules and Regulations for Insurance of Accounts*, and must also meet the requirements of any state laws and regulations, if applicable, requiring the maintenance of reserves. Frequently, reserves established to meet the requirements of federal regulations, if applicable and so designated, are adequate to meet the requirements of state reserve laws and regulations.

The charters of some associations contain provisions relating to reserve requirements. In some special situations, agreements with, or restrictions imposed by, supervisory authorities may affect reserve requirements.

Income Tax Reserve for Bad Debts

If a savings and loan association meets certain special tests and limitations provided in the Internal Revenue Code, deductions from taxable income are permitted for annual additions to a reserve for bad debts, computed in accordance with special provisions of the code. The special tests provided in the code and federal income tax regulations pertain principally to investments in qualifying assets and to the percentage of qualifying gross income to total gross income. For federal income tax purposes, the reserve for bad debts need not be separately identified in financial statements and may be greater or less than the supervisory reserves previously described. In any event, an association must comply with both the supervisory regulations governing the general reserves and the Internal Revenue Code and the related regulations governing the income tax reserve for bad debts.

The Accounting Principles Board concluded in Opinion no. 23 that tax allocation is not required for the difference

between taxable income and pretax accounting income attributable to a tax bad debt reserve. If circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the tax bad debt reserves for other than bad debt losses, income taxes attributable to those reductions should be accrued as tax expenses of the current period; the accrual of those income taxes should *not* be accounted for as an extraordinary item.

In considering the likelihood of payment of income taxes because of reductions in reserves (other than from bad debt losses charged to the reserves), consideration should be given to whether the association is likely to take an action that will create a tax liability and whether, under existing rules and regulations, supervisory authorities will permit the use of such reserves for purposes that will create a tax liability. The consideration should apply to both capital stock and mutual associations; although, with rare exceptions (for example, liquidations), distributions by mutual associations to their members are deductible as interest for tax purposes. It is unlikely that income tax would become payable in the future as a result of the use of general reserves for this purpose. The independent auditor ordinarily should obtain written representations from management to the effect that no action has been taken nor is any action contemplated that would cause any portion of the general reserves to be subject to income tax.

Audit Considerations

The independent auditor should become familiar with the reserve requirements of the association's charter and applicable state regulations and the *Rules and Regulations for the Federal Savings and Loan System*. For all associations insured by the FSLIC, the auditor should also consider the applicable requirements of the *Rules and Regulations for Insurance of Accounts*.

The auditor should also be familiar with the special provisions of federal, state, and local tax laws affecting the reserves of savings and loan associations.

The independent auditor should review the general reserves for compliance with applicable rules and regulations

and should consider whether deviations should be disclosed. The independent auditor should also consider whether deviations should be discussed with the supervisory agent of the FHLB and the district director—examinations of the FHLBB.

The auditor should determine if there are any significant restrictions on the use of retained earnings for the payment of dividends and interest. The restrictions include absolute restrictions, such as those imposed by state laws or credit agreements and those resulting from an additional income tax requirement before payment of dividends and interest. The most restrictive limitations should be disclosed in the balance sheet or notes.

Income

Most savings and loan associations derive the majority of their income from interest on loans (mortgage, property improvement, consumer credit, savings accounts, real estate sold under contract, and so forth). Other prime sources include loan commitment fees, fees for originating loans in-house, other loan fees and service charges, income from security investments, insurance commissions, escrow and trustee fees, rentals from REO, and gains on sale of real estate. Other sources of income may include appraisal fees, membership and transfer fees, fines, and rentals of safe deposit boxes. An association's policies on recording income should be determined and sufficient tests made to ascertain that the policies are consistently applied and that they are in conformity with generally accepted accounting principles.

Material fluctuations in income should be investigated and satisfactory explanations obtained.

Loan Commitment Fees

Savings and loan associations are highly regulated by federal and/or state supervisory authorities. For example, regulations provide that federally chartered associations must invest primarily in residential mortgage loans. Regulations

also govern their investments in other types of loans. In addition, the amount (percent) and the timing for recognition of commitment fees and origination fees (acquisition credits) of loans made or purchased are limited by federal regulations. Federal income tax regulations also provide incentives for associations to make loans collateralized by residential properties.

Associations primarily make or purchase mortgage loans to be held as long-term investments. They make the bulk of loans directly with the purchasers of the properties. However, in recent years, secondary markets have accounted for a significant volume of the investment in mortgages by associations. The latter activity has been encouraged by governmental regulations to provide additional funds for housing.

The significant volume of activity of associations in making and purchasing loans gives them an ability to determine objectively market terms and yields on mortgages. The terms and yields are widely publicized locally, regionally, and nationally. In developing the accounting for loan commitment fees as discussed below, consideration has been given to the environment in which savings and loan associations operate.

Associations often receive nonrefundable commitment fees for entering into binding agreements with prospective borrowers or sellers of loans. The fees assure financing by the association for a specified period of time or at a specified date. While the types of commitment fees may vary, they usually are identified as one or more of the following:

- A fee paid to provide financing at the market rate in existence at the time the loan is to be drawn down.
- A fee paid to guarantee financing at or near the market rate at the time the commitment is made.
- A fee paid to guarantee that a lender of funds for construction purposes will be “taken out” of the construction (nonpermanent) loan.
- A fee paid to obtain a take-out commitment, guaranteed by a commitment letter, with little expectation that the loan committed will be funded by the issuer of the letter.

Commitment fees received by savings and loan associations may represent compensation for the cost of underwriting the commitment, a fee for the earmarking of funds or compensation for a service rendered (for example, the act of making the commitment), a fee for the assumption of the risk of adverse changes in market interest rates, and/or an adjustment of the yield on the loan.

The income from commitment fees has been recorded in a variety of ways including recognition—

- In full when received.
- When the commitment period has expired or the loan has been drawn down.
- Ratably over the commitment period.
- Ratably over the combined commitment and loan period; if the loan is not drawn down, the balance of the fee is recognized at the expiration of the commitment period.

The accounting for recognition of income from commitment fees should be based on the nature and substance of the transactions. The accounting methods that most frequently apply to the types of transactions for savings and loan associations are discussed below.

- Amounts equal to direct underwriting costs should be recognized as income at the time the commitment fee becomes a contractual obligation. Commitment fees that are not received in cash should be evaluated for collectibility.
- Amounts representing compensation for the earmarking of funds or for a service rendered in issuing the commitment should be deferred and amortized over the commitment period using the straight-line method.
- Fees representing the assumption of the risk of adverse changes in market interest rates should be deferred until the loan is drawn down. At the time the loan is drawn down, the current market interest rate and the contract interest rate on the loan should be compared. If the

current market interest rate at that time is the same as or lower than the contract interest rate on the loan, the fee should be recognized as income. If the current market interest rate is higher than the contract interest rate on the loan at the time the loan is drawn down, the fee should be deferred and amortized over the loan period (the average loan life expectancy for a particular category of loans) using the interest method.

- Amounts representing an adjustment of the yield on the loan should be deferred and amortized over the combined commitment and loan period (the average loan life expectancy for a particular category of loans). The straight-line method of amortization should be used during the commitment period and the interest method should be used for the remaining balance during the loan period.
- Unamortized commitment fees should be recognized as income at the end of the commitment period if the loan is not funded.

Savings and loan associations should review all the circumstances related to the financing transactions in determining the proper accounting method for each commitment fee. Recognition of commitment fees in full when received does not reflect sufficient consideration of the nature and substance of the transaction and, therefore, is not appropriate, except to the extent the fees represent reimbursement of direct underwriting costs. Direct underwriting costs include the costs of salaries and related fringe benefits of loan underwriting personnel, appraisals, site inspections, processing, and other direct expenses incurred in excess of those recoverable as fees for originating loans in-house, which are discussed in the next section.

As previously stated, savings and loan associations have the ability to objectively determine market interest rates on mortgage loans made and purchased, based on their significant volume of activity in local, regional, and national mortgage markets. This ability provides associations with the basis to determine the nature and substance of commitment fees and thus the proper method for recognizing such income

in accordance with principles established for floating or fixed rate commitments as discussed below.

Floating Rate Commitment Fees

A *floating rate commitment* is defined as a commitment to provide financing at the market interest rate to be determined at the time the loan is drawn down or the purchase transaction is to be settled.

A floating rate commitment fee may compensate for the cost of underwriting the commitment, for the earmarking of funds, and/or for a service rendered. The presumption is that the interest rates on such loans will approximate the market interest rate in existence at the time the loan is drawn down or the purchase transaction settled. As discussed previously, fees equal to direct underwriting costs should be recognized as income at the time the commitment fee becomes a contractual obligation. Also, since fees representing compensation for the earmarking of funds and/or for a service rendered are given the same accounting treatment, a floating rate commitment fee, in excess of direct underwriting costs, should be deferred and amortized over the commitment period using the straight-line method of amortization.

Fixed Rate Commitment Fees

A *fixed rate commitment* is defined as a commitment to provide financing at an interest rate determined at the time the commitment is made.

A fixed rate commitment fee may compensate for the cost of underwriting the commitment, may adjust the yield on the loan, or may compensate for the assumption of the risk of adverse changes in market interest rates, for the earmarking of funds, and/or for a service rendered. It is not practicable to separate a fixed rate commitment fee into all its components. Accordingly, such a fee, in excess of direct underwriting costs, should be deferred and amortized over the combined commitment and loan period (the average loan life expectancy for a particular category of loans). The straight-line method of amortization should be used during the commitment period. When the loan is drawn down or the

purchase transaction settled, the current market interest rate should be compared with the contract interest rate on the loan. If the current market interest rate is the same as or lower than the contract interest rate on the loan, the remaining unamortized fixed rate commitment fee should be recognized as income. If the current market interest rate at the time the loan is drawn or purchase transaction is settled is higher than the contract interest rate on the loan, the remaining unamortized fixed rate commitment fee should be deferred and amortized over the loan period (the average loan life expectancy for a particular category of loans) using the interest method.

If a fixed rate commitment is made for a loan collateralized by an existing residence, the time necessary to process the loan application normally does not exceed thirty to sixty days. The association enters this type of agreement because the market rates for residential loans historically have not fluctuated significantly over such a short period. Under the circumstances, it would be acceptable to amortize this type of commitment fee over the commitment period, since the market interest rate expected to exist at the time the loan is drawn down will not significantly differ from the rate stated in the commitment (the market rate at the time the commitment is made).

When fees are received in connection with commitments to purchase loans in the secondary market, the commitment period should be of sufficient duration to warrant the accounting treatment applicable to the components of a fee discussed earlier in this section. Otherwise, such commitment fees, in excess of an amount equal to direct underwriting costs, should generally be considered an adjustment of yield and amortized over the combined commitment and loan period. In determining whether a commitment period is of sufficient duration, considerations should include the market environment affecting the level of interest rates. For example, in a stable interest rate market environment, a commitment period of less than thirty days may not be considered to be of sufficient duration. In contrast, during a period of anticipated rapid increases in a volatile interest rate market environment, a commitment period of less than thirty days may be considered to be of a sufficient duration. Judgment must

be exercised to provide that fees are accounted for in accordance with the substance of the transaction.

The amount of unamortized loan commitment fees applicable to loans made or purchased should be deducted from the related loans receivable in the statement of financial condition. The amount should be disclosed either on the face of the financial statements or in the notes.

For federal regulatory purposes, commitment fees may be regarded as acquisition credits that are subject to regulations that may permit immediate recognition as income or require deferral and amortization in a manner not in conformity with generally accepted accounting principles. (See the section entitled "Timing of the Audit" for a discussion of how variances between generally accepted accounting principles and regulatory requirements are treated in reports to the FHLBB.)

Fees for Originating Loans In-House

Savings and loan associations usually receive fees for originating loans in-house. The normal origination fee is essentially a reimbursement for the costs of the underwriting process of obtaining appraisals, processing the loan application, reviewing legal title to the real estate, and other procedures. Origination fees, to the extent they are a reimbursement for such costs, should be recognized in income at the time the loans are made, since the costs of the services are normally charged to expense as incurred. Any fees in excess of that amount should be accounted for as an adjustment of yield. Since determination of origination costs is difficult, fees other than commitment fees allowed to be recognized as current income by FSLIC regulations may be recorded as income at loan closing. Fees based on such amounts generally do not exceed origination costs.

If the portion of a loan commitment fee equal to direct underwriting costs has been recognized as income, no additional immediate income from all or a portion of loan origination fees should be recognized, except to the extent that additional loan underwriting costs are incurred. Unamortized loan origination fees remaining after the loan is

funded should be deducted from the related loans in the statement of financial condition and be amortized to income over the loan period by application of the interest method.

Expenses

Interest on Savings Accounts

Interest paid or credited on individual savings accounts during the audit period should be tested for proper computation and recording in the accounts. In addition, an overall test should be made of the total interest paid or credited during the period.

The independent auditor should ascertain the date to which interest on savings accounts has been recorded on the books of the association. When that date does not coincide with the audit date, interest expense should be adjusted if the amount is material. Otherwise, it may be necessary for the auditor to modify the report on the financial statements.

Other Expenses

Other expenses should be examined using substantially the same procedures followed in other industries, performed in accordance with generally accepted auditing standards.

Accounting for Business Combinations of Associations

Generally accepted accounting principles for combinations of business corporations and guides for application of those principles are set forth in APB Opinion no. 16. Since savings and loan associations possess the relevant characteristics of other business corporations, Opinion no. 16 is equally applicable to business combinations of capital stock associations, two or more mutual associations, or a capital stock association and one or more mutual associations. Although mutual associations have no capital stock, the holders of savings accounts may be regarded as having a form of equity interest in those associations. Therefore, if a merger or other combination involving one or more mutual associations meets the applicable criteria (other than those pertaining to stock own-

ership) set forth in APB Opinion no. 16, the combination should be accounted for by the pooling-of-interests method. All other combinations should be accounted for by the purchase method as described in APB Opinion no. 16 and FASB Interpretation no. 9, *Applying APB Opinions nos. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*.

Chapter 4

The Auditor's Report

The independent auditor reporting on the financial statements of savings and loan associations is governed by generally accepted auditing standards that apply to the financial statements of companies in other industries. Standards are established and interpreted by the auditing standards executive committee of the AICPA.

Insured associations are subject to accounting rules prescribed by the FHLBB under the *Rules and Regulations for Insurance of Accounts*. Thus, the independent auditor occasionally may encounter accounting requirements that differ from generally accepted accounting principles. In view of this, special attention should be paid to sections 544.02 and .04 of SAS no. 1, which deal with reporting on regulated companies; SAS no. 14, *Special Reports*; and paragraphs 15–18 of SAS no. 2, dealing with reporting if there is departure from a generally accepted accounting principle. Some of the more common variances stem from the accounting requirements for items such as these:

1. The amortization of premiums or discounts on loans and securities.
2. Real estate owned.
3. Report presentation of undisbursed portion of mortgage loans.
4. Recording of profits or losses from the sale of real estate.
5. Gains or losses on securities transactions.
6. Loan commitment fees and fees for originating loans in-house.

7. The provision for losses on loans.
8. Distribution of stock dividends.

If variances from generally accepted accounting principles are material in amount, the independent auditor should determine how to modify his opinion. The auditor's report should specifically refer to the variance and should give a clear explanation of the nature of the modifications and the effect of the variance, if applicable, on the financial condition and results of operations. The management of an association may agree with the auditor's recommended adjustments but not record the adjustments because it must file regulatory reports on a different basis. It may be acceptable to reflect the unrecorded adjustments in the association's financial statements and incorporate a reconciliation of the different bases in a footnote to the financial statements or as supplementary information. (See section entitled "Timing of the Audit" for a discussion of the reporting of differences.)

The FHLBB *Statement of Policy Concerning Acceptability of Auditors and Audits* and its PA bulletins state the FHLBB requirements for audits of savings and loan associations. The bulletins provide that the auditor should refer any separate report to the association's board of directors, such as a report on internal accounting control.

Other specific requirements of the FHLBB pertaining to the scope of the audit and the independent auditor's report are similar to those required under generally accepted auditing standards and are therefore not discussed in this guide.

Illustrative Financial Statements for a Mutual Association (Consolidated) and a Stock Association

Following are sample illustrative financial statements of a mutual association, prepared on the consolidated basis, and of a stock association, without a consolidated subsidiary, reflecting the practices described in the foregoing material. The sample financial statements do not include all of the accounts and transactions that might be found in practice; they are for illustrative purposes only.

The financial statements for a stock association may not be substantially different from those of a mutual association. The principal differences are the addition of a stockholders' equity section in the statement of financial condition and a statement of stockholders' equity, which replace the statement of retained earnings for a mutual association. Also, earnings per share is presented in the statement of operations. The accountant's report reflects the differences.

The format of the illustrative financial statements is one way to present the basic financial statements for savings and loan associations. The notes indicate the subject matter generally required to be disclosed, but should be expanded, reduced, or modified to suit individual circumstances.

As previously stated, the accountant should be familiar with the rules and regulations of the FHLBB, FSLIC, and FHLB systems, including those that relate to the form and content of financial statements. At present, the FHLBB requires presentation of separate summary financial statements of each service corporation and joint venture of an institution or its subsidiaries. An example of financial statements of two service corporations is presented in the illustrative financial statements as supplementary note information. Summary financial statements may also be included with financial statements as supplemental or other financial information (not illustrated). Information presented in that manner may not be cov-

ered by the accountant's report on the basic financial statements, but instead covered by a separate "second" opinion on the supplemental information (SAS no. 1, section 610).

Illustrative consolidated financial statements for a savings and loan holding company have not been included. However, most of the disclosures illustrated for the stock association are equally appropriate for holding companies.

In addition to reporting on the basic financial statements, the independent accountant is required by the FHLBB to report on internal accounting controls, FHLBB mortgage collateral verification, and mortgage servicing for the Federal Home Loan Mortgage Corporation and perhaps for other mortgage investors.

A Mutual Association (Consolidated)

To the Board of Directors
Mutual Savings and Loan Association:

We have examined the consolidated statements of financial condition of Mutual Savings and Loan Association and Subsidiaries as of September 30, 19X7 and 19X6, and the related consolidated statements of operations, retained earnings, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Mutual Savings and Loan Association and Subsidiaries as of September 30, 19X7 and 19X6, and the consolidated results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Signature

City, State

Date

Mutual Savings and Loan Consolidated Statements

<u>Assets</u>	<u>September 30</u>	
	<u>19X7</u>	<u>19X6</u>
Cash (including certificates of deposit of \$1,300,000 (19X7) and \$2,400,000 (19X6))	\$ 1,563,478	\$ 2,751,112
Investment securities (Note 5)		
U.S. government (including agencies)		
Market value of \$2,346,000 (19X7) and \$2,141,000 (19X6)	2,400,100	2,200,038
Municipals		
Market value \$1,970,000 (19X7) and \$2,474,000 (19X6)	2,125,008	2,565,093
Other		
Marketable equity securities carried at market in 19X7 and at cost in 19X6 (cost in 19X7 of \$411,150; market in 19X6 of \$283,000)	365,000	275,055
Loans receivable, net (Notes 2 and 4)	136,134,319	119,997,601
Real estate		
Acquired in settlement of loans, less allowance for losses of \$85,566 (19X7) and \$70,141 (19X6)	1,101,238	1,423,676
Acquired for development (Notes 5 and 10)	1,119,578	1,176,295
Office properties and equipment, at cost, less accumulated depreciation of \$1,127,888 (19X7) and \$1,006,424 (19X6)	5,034,036	4,793,748
Federal Savings and Loan Insurance Corporation secondary reserve pre-payment	997,723	972,155
Federal Home Loan Bank stock, at cost (Note 4)	2,073,400	1,291,700
Accrued interest receivable	843,874	736,453
Other assets	635,840	283,100
	<u>\$154,393,594</u>	<u>\$138,466,026</u>

The accompanying notes are an integral part of the consolidated financial statements.

Association and Subsidiaries of Financial Condition

	<i>September 30</i>	
<u><i>Liabilities and retained earnings</i></u>	<u>19X7</u>	<u>19X6</u>
Savings accounts (Note 3)	\$119,162,437	\$114,532,863
Advances from Federal Home Loan Bank (Note 4)	24,880,000	13,500,000
Other borrowed money (Notes 5 and 10)	1,361,615	2,800,000
Advances from borrowers for taxes and insurance	701,141	677,576
Federal income taxes (Note 7)		
Current	36,300	29,000
Deferred	234,700	187,000
Other liabilities	<u>2,295,585</u>	<u>1,144,700</u>
Total liabilities	<u>148,671,778</u>	<u>132,879,139</u>
Retained earnings—substantially restricted (Note 6)	5,767,966	5,594,887
Net unrealized loss on marketable equity securities	<u>(46,150)</u>	<u>—</u>
Retained earnings—net	<u>5,721,816</u>	<u>5,394,887</u>
Commitments (Note 9)		
	<u><u>\$154,393,594</u></u>	<u><u>\$138,466,026</u></u>

**Mutual Savings and Loan Association and
Subsidiaries
Consolidated Statements of Operations**

	<i>Years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Income		
Interest on loans	\$ 9,536,204	\$ 8,136,598
Loan fees	687,413	503,279
Interest and dividends on investments	493,840	425,654
Gain (loss) on sales of investments, net	37,250	(14,919)
Gain (loss) on sales of loans, net	(63,717)	27,469
Gain on sale of real estate, net (Note 10)	37,096	27,418
Other	<u>66,285</u>	<u>66,028</u>
Total income	10,794,371	9,171,527
Expenses		
Interest on savings accounts	7,006,533	6,048,663
Interest on advances and other borrowed money	<u>1,512,508</u>	<u>776,880</u>
	8,519,041	6,825,543
Less: Interest capitalized	<u>(98,000)</u>	<u>(71,000)</u>
	8,421,041	6,754,543
General and administrative expenses (Notes 8 and 9)	1,404,635	1,323,625
Loss provisions and expenses of loans and real estate owned, net	187,769	176,077
Other	<u>519,847</u>	<u>461,778</u>
Total expenses	<u>10,533,292</u>	<u>8,716,023</u>
Income before provision for federal income taxes	261,079	455,504
Provision for federal income taxes (Notes 6 and 7)		
Current	40,300	29,000
Deferred	<u>47,700</u>	<u>111,000</u>
Total income tax provision	<u>88,000</u>	<u>140,000</u>
Net income	<u><u>\$ 173,079</u></u>	<u><u>\$ 315,504</u></u>

The accompanying notes are an integral part of the consolidated financial statements.

**Mutual Savings and Loan Association and
Subsidiaries
Consolidated Statements of Retained Earnings**

For the years ended September 30, 19X7 and September 30, 19X6

Balance October 1, 19X5	\$5,279,383
Net income for the year ended September 30, 19X6	<u>315,504</u>
Balance September 30, 19X6	\$5,594,887
Net income for the year ended September 30, 19X7	173,079
Net unrealized loss on marketable equity securities	<u>(46,150)</u>
Balance September 30, 19X7	<u><u>\$5,721,816</u></u>

The accompanying notes are an integral part of the consolidated financial statements.

Mutual Savings and Loan Consolidated Statements of

	<i>Years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Sources of funds		
From operations		
Net income	\$ 173,079	\$ 315,504
Add (deduct) items not affecting funds:		
Provisions for losses on loans and real estate	93,000	79,517
Provision for depreciation and amortization	224,836	219,508
Other—net	<u>(30,717)</u>	<u>74,474</u>
Funds provided from operations	460,198	689,003
Decrease in cash	1,187,634	—
Decrease in investment securities	150,078	403,758
Loan principal repayments	21,575,117	18,079,581
Cost of		
Sales of participating interests in loans	2,017,131	3,493,227
Sale of real estate acquired in settlement of loans	704,497	1,605,142
Sale of real estate development	609,385	207,142
Interest credited to savings accounts	4,904,573	4,294,551
Advances from Federal Home Loan Bank	11,380,000	14,500,000
Increase in advances from borrowers for taxes and insurance	23,565	72,413
Additions of other borrowed money	400,000	—
Other	<u>552,060</u>	<u>245,718</u>
	<u>\$43,964,238</u>	<u>\$43,590,535</u>

The accompanying notes are an integral part of the consolidated financial statements.

Association and Subsidiaries Changes in Financial Position

	<i>Years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Uses of funds		
Increase in cash	\$ —	\$ 1,387,517
Loan disbursements	37,732,239	36,643,270
Purchase of loans and participat- ing interests in loans	1,996,727	2,457,519
Additions to real estate acquired in settlement of loans	344,469	493,056
Additions to real estate acquired for development	542,178	285,330
Purchase of Federal Home Loan Bank stock	781,700	—
Additions to office properties and equipment	494,352	456,695
Net changes in savings accounts before interest credited	234,188	(1,332,852)
Repayments of advances from Federal Home Loan Bank	—	2,500,000
Repayments of other borrowed money	<u>1,838,385</u>	<u>700,000</u>
	<u>\$43,964,238</u>	<u>\$43,590,535</u>

Mutual Savings and Loan Association and Subsidiaries

Notes to Consolidated Financial Statements

September 30, 19X7 and September 30, 19X6

1. *Summary of Significant Accounting Policies*

Principles of consolidation. The accompanying consolidated financial statements include the accounts of Mutual Savings and Loan Association and its wholly owned subsidiaries. All significant intercompany balances and transactions between the association and its wholly owned subsidiaries have been eliminated.

Investment securities. Investment securities, except for marketable equity securities, are stated at cost, adjusted for amortization of premiums, and accretion of discounts on purchase. Marketable equity securities have been stated at the lower of aggregate cost or market. At September 30, 19X6, market exceeded cost on these securities and, as a result, they were carried at cost. A valuation allowance (reducing the carrying amount of investment securities to market) was established at September 30, 19X7. The amount of the valuation account (\$46,150) represents the net unrealized loss on investment securities and was established by a charge to retained earnings.

Loan commitment fees. Nonrefundable fees received for commitments to make or purchase loans in the future are deferred to the extent that they exceed the direct costs of underwriting the commitments. For commitments issued to make or purchase loans at market interest rates established at the time the commitments are funded (floating rate commitments), fees in excess of direct underwriting costs are amortized ratably over the commitment period. For commitments issued to make or purchase loans at market rates established at the time the commitments are issued (fixed-rate commitments), fees in excess of direct underwriting costs are amortized over the combined commitment (on the straight-line method) and loan (on the interest method) period. Unamortized fixed-rate commitment fees are recognized as income at the time the loans are made or purchased transactions settled if the market interest rate at such time for similar loans are the same as or lower than the interest rate fixed when the commitment was issued. Non-refundable commitment fees received for commitments to make loans on existing residences, which are usually funded within approximately 60 days, are amortized to income over the commitment period.

Loan origination fees, discounts, and premiums. The portion of loan origination fees that exceeds the direct costs of underwriting and closing loans is deferred. The deferred fees and discounts received in connection with mortgage loans made and purchased are amortized to income over the average life of mortgage loans, estimated to be ten years, using the interest method. Premiums on purchased loans are generally amortized over a period of ten years using the interest method.

Unearned income on home improvement and mobile home loans is amortized over the term of the loans using the interest method.

Real estate. Real estate is carried at the lower of cost (fair value for real estate acquired in settlement of loans) or net realizable value.

Depreciation. The association computes depreciation and amortization generally on the straight-line method for both financial reporting and federal income tax purposes. The estimated useful lives used to compute depreciation and amortization are—buildings, forty years; equipment, three to fifteen years; and leasehold improvements, over the life of the lease or the life of the improvements, whichever is less.

Allowance for losses. It is the policy of the association to provide valuation allowances for estimated losses on loans and real estate when a significant and permanent decline in value occurs. In providing valuation allowances, costs of holding real estate, including the cost of capital are considered. Major loans, real estate owned including development projects, and major lending areas are reviewed periodically to determine potential problems at an early date. The association's experience has shown that foreclosures on loans result in some loss. Therefore, in addition to allowances for specific loans, the association makes a provision for losses on properties based in part on loss experience and in part on prevailing market conditions. Additions to allowances are charged to earnings.

Income taxes. Deferral of income taxes results primarily from preparing tax returns on the cash basis of accounting and preparing the financial statements on the accrual basis of accounting, and from different methods of accounting for loan fees.

The investment tax credit is accounted for on the flow-through method.

2. *Loans Receivable.* Loans receivable at September 30, 19X7 and 19X6, consisted of the following.

	<u>19X7</u>	<u>19X6</u>
First mortgage loans	\$135,823,722	\$122,273,578
Insured and GNMA guaranteed loans	3,855,723	1,945,596
Loans to depositors, secured by savings	1,300,338	916,045
Mobile home loans	1,152,920	654,599
Property improvement loans	783,469	620,120
Other loans	<u>56,217</u>	<u>50,822</u>
	142,972,389	126,460,760
Less		
Undisbursed portion of mortgage loans	6,115,041	5,873,279
Unearned discounts	624,100	512,240
Allowance for losses	<u>98,929</u>	<u>77,640</u>
	<u>\$136,134,319</u>	<u>\$119,997,601</u>

At September 30, 19X7 and 19X6, loans receivable included \$4,000,000 and \$4,200,000, respectively, of loans collateralized by multifamily residential properties the terms of which were modified. Interest on these loans under the original terms would have been approximately \$350,000 and \$375,000 for the years ended September 30, 19X7 and 19X6, respectively. Interest income recorded under the modified terms was \$120,000 and \$100,000, respectively, for the two years. The association is not committed to lend additional funds to debtors whose loans have been modified.

3. *Savings Account Analysis*

	<u>September 30</u>			
<u>Balances by interest rate</u>	<u>19X7</u>		<u>19X6</u>	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
5.25% Passbook Certificate Accounts:	<u>\$ 47,664,975</u>	<u>40%</u>	<u>\$ 44,667,817</u>	<u>39%</u>
5.25 to 5.75%	27,407,361	23	45,813,145	40
5.75 to 6.5%	17,874,366	15	12,598,615	11
6.5% and over	<u>26,215,735</u>	<u>22</u>	<u>11,453,286</u>	<u>10</u>
	<u>71,497,462</u>	<u>60%</u>	<u>69,865,046</u>	<u>61%</u>
	<u>\$119,162,437</u>	<u>100%</u>	<u>\$114,532,863</u>	<u>100%</u>

4. *Advances From Federal Home Loan Bank.* The advances from the Federal Home Loan Bank consisted of the following:

	<i>Interest rate</i>	<i>September 30</i>	
		<i>19X7</i>	<i>19X6</i>
Due within one year:	8½% to 9%	\$ —	\$10,500,000
	9% to 10%	12,200,000	—
	11½%	3,700,000	—
Other—all due within five years:	7½% to 8%	2,500,000	3,000,000
	9% to 10%	6,480,000	—
		<u>\$24,880,000</u>	<u>\$13,500,000</u>

These advances are collateralized by Federal Home Loan Bank stock and certain first mortgage loans.

5. *Other Borrowed Money.* Other borrowed money consisted of the following:

	<i>September 30</i>	
	<i>19X7</i>	<i>19X6</i>
9¾% note, due August 19X7	\$ —	\$ 1,636,770
10¼% note, due August 19X8	290,354	—
9% mortgage loan, due October 19X9	<u>1,071,261</u>	<u>1,163,230</u>
	<u>\$1,361,615</u>	<u>\$ 2,800,000</u>

The 10¼ percent note is collateralized by investment securities with a carrying value of \$375,000.

The 9 percent mortgage loan is collateralized by lots in a land development project. A principal payment of \$10,000 is required for each lot sold, with any remaining unpaid balance due in October 19X9.

6. *Retained Earnings.* In connection with the insurance of savings accounts the association is required to maintain a federal insurance reserve. The reserve, which aggregated \$4,550,955 at September 30, 19X7, is not a valuation allowance and has not been created by charges against earnings. It represents a restriction on retained earnings of the association.

The association is allowed a special bad debt deduction limited generally in the current year to 42 percent (declining to 40 percent in 1979) of otherwise taxable income and subject to certain limitations based on aggregate loans and savings account balances at the end of the year. If the amounts that qualify as deductions for

federal income tax purposes are later used for purposes other than for bad debt losses, they will be subject to federal income tax at the then current corporate rate. Retained earnings at September 30, 19X7, include \$4,841,965 for which federal income tax has not been provided.

7. *Federal Income Tax.* Deferred tax expense results from timing differences in the recognition of income and expense for tax and financial reporting purposes. The sources of the differences and the related tax effects were as follows:

	<i>Years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Loan fees recognized for financial reporting purposes when loans are recorded but deferred for tax purposes	\$96,000	\$107,000
Interest capitalized as part of real estate development costs in the financial statements but expensed for tax purposes	98,000	71,000
Income and expenses recognized in the financial statements on the accrual basis but on the cash basis for tax purposes	(99,500)	(6,000)
Other	(17,000)	12,000
Effect of allowable federal tax bad debt deduction applied to above (net of preference tax)	<u>(29,800)</u>	<u>(73,000)</u>
	<u>\$47,700</u>	<u>\$111,000</u>

The provision for federal income taxes differs from that computed at the statutory 48 percent corporate tax rate, as follows:

	<i>Years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Tax at statutory rate	\$125,300	\$218,600
Increases (decreases) in taxes:		
Bad debt deduction based on percentage of income (net of applicable preference tax)	(49,200)	(87,300)
Provisions for loan and real estate losses	25,900	21,800
Other	<u>(14,000)</u>	<u>(13,100)</u>
	<u>\$ 88,000</u>	<u>\$140,000</u>

8. *Employee Benefits.* The association maintains an insured, contributory pension plan for its employees. The association's policy is to fund pension costs accrued. The total pension expense was \$41,994 in 19X7 and \$46,311 in 19X6 and includes amortization of prior service cost over a twenty-five-year period. The actuarially computed value of vested benefits at January 1, 19X7, the latest valuation date, exceeded the plan assets stated at cost (which approximates market) by approximately \$77,500.

9. *Lease Commitments.* Rentals under long-term operating leases for property amounted to \$92,039 in 19X7 and \$56,938 in 19X6. The amounts have been reduced by rental income of \$59,581 in 19X7 and by \$59,830 in 19X6 from subleases of one to four years in duration. At September 30, 19X7, the minimum rental commitments under all noncancelable leases with initial or remaining terms of more than one year are as follows:

<u>Years ending September 30</u>	<u>Gross rental expense</u>	<u>Rental income from subleases</u>	<u>Net rental expense</u>
19X8	\$ 151,620	\$33,158	\$ 118,462
19X9	153,695	21,180	132,515
19X0	154,111	4,775	149,336
19X1	154,111	—	154,111
19X2	154,111	—	154,111
Later years	2,568,283	—	<u>2,568,283</u>
Total minimum pay- ments required— net			<u><u>\$3,276,818</u></u>

10. *Supplementary Information, Consolidated Subsidiaries.* The following condensed statements summarize the financial positions and operating results of the association's wholly owned subsidiaries. Intercompany balances and transactions are noted parenthetically.

		Summary Statements of September 30,			
		<i>Land development subsidiary</i>		<i>Other subsidiary</i>	
<u>Assets</u>		<u>19X7</u>	<u>19X6</u>	<u>19X7</u>	<u>19X6</u>
Cash (other subsidiary—\$11,420 and \$10,100 savings account with parent in 19X7 and 19X6, respectively)	\$	23,238	\$ 17,542	\$24,870	\$18,650
Accounts receivable (\$14,200 and \$8,050 from parent in 19X7 and 19X6, respectively)		—	—	28,412	16,111
Real estate acquired for development at lower of cost or estimated net realizable value		1,119,578	1,176,295	—	—
Equipment (less accumulated depreciation of \$4,968 in 19X7, and \$3,374 in 19X6)		—	—	18,834	20,428
Other assets		<u>147,559</u>	<u>151,297</u>	<u>7,212</u>	<u>5,871</u>
		<u>\$1,290,375</u>	<u>\$1,345,134</u>	<u>\$79,328</u>	<u>\$61,060</u>

Financial Condition
19X7 and 19X6

<i>Liabilities and stock- holders' equity</i>	<i>Land development subsidiary</i>		<i>Other subsidiary</i>	
	<i>19X7</i>	<i>19X6</i>	<i>19X7</i>	<i>19X6</i>
Notes payable	\$1,071,261	\$1,163,230	\$ —	\$ —
Federal income taxes payable				
Current	8,878	8,168	15,327	3,007
Deferred	25,400	16,472	—	—
Other liabilities	<u>42,121</u>	<u>33,839</u>	<u>43,284</u>	<u>53,289</u>
Total liabili- ties	<u>1,147,660</u>	<u>1,221,709</u>	<u>58,611</u>	<u>56,296</u>
Stockholders' eq- uity	<u>142,715</u>	<u>123,425</u>	<u>20,717</u>	<u>4,764</u>
	<u>\$1,290,375</u>	<u>\$1,345,134</u>	<u>\$79,328</u>	<u>\$61,060</u>

Summary Statements of Operations
For the Years Ended September 30, 19X7 and 19X6

	<i>Land development subsidiary</i>		<i>Other subsidiary</i>	
	<u>19X7</u>	<u>19X6</u>	<u>19X7</u>	<u>19X6</u>
Income				
Sales of real estate	\$731,262	\$587,491	\$ —	\$ —
Other (\$195,248 and \$110,791 from parent in 19X7 and 19X6, respectively)	<u>—</u>	<u>—</u>	<u>312,420</u>	<u>180,544</u>
Total income	731,262	587,491	312,420	180,544
Expenses				
Cost of real estate sold	609,385	489,575	—	—
Other expenses	<u>84,781</u>	<u>70,498</u>	<u>281,140</u>	<u>174,280</u>
Total expenses	<u>694,166</u>	<u>560,073</u>	<u>281,140</u>	<u>174,280</u>
Income before pro- vision for federal income taxes	37,096	27,418	31,280	6,264
Provision for fed- eral income taxes:				
Current	8,878	8,168	15,327	3,007
Deferred	<u>8,928</u>	<u>4,992</u>	<u>—</u>	<u>—</u>
Tax provision	<u>17,806</u>	<u>13,160</u>	<u>15,327</u>	<u>3,007</u>
Net income	<u>\$ 19,290</u>	<u>\$ 14,258</u>	<u>\$ 15,953</u>	<u>\$ 3,257</u>

A Stock Association

To the Board of Directors
Stock Savings and Loan Association:

We have examined the statements of financial condition of Stock Savings and Loan Association as of September 30, 19X7 and 19X6, and the related statements of operations, stockholders' equity, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Stock Savings and Loan Association as of September 30, 19X7 and 19X6, and the results of its operations and changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Signature

City, State

Date

Stock Savings and Statements of

<u>Assets</u>	<u>September 30</u>	
	<u>19X7</u>	<u>19X6</u>
Cash (including certificates of deposit of \$1,300,000 (19X7) and \$2,400,000 (19X6))	\$ 1,563,478	\$ 2,751,112
Investment securities (Note 5)		
U.S. government (including agencies)		
Market value \$2,346,000 (19X7) and \$2,141,000 (19X6)	2,400,100	2,200,038
Municipals		
Market value \$1,970,000 (19X7) and \$2,474,000 (19X6)	2,125,008	2,565,093
Other		
Securities carried at market in 19X7 and at cost in 19X6 (cost in 19X7 of \$411,150; market in 19X6 of \$283,000)	365,000	275,055
Loans receivable, net (Notes 2 and 4)	136,134,319	119,997,601
Real estate		
Acquired in settlement of loans less allowance for losses of \$85,566 (19X7) and \$70,141 (19X6)	1,101,238	1,423,676
Acquired for development (Note 5)	1,119,578	1,176,295
Office properties and equipment, at cost, less accumulated depreciation of \$1,127,888 (19X7) and \$1,006,424 (19X6)	5,034,036	4,793,748
Federal Savings and Loan Insurance Corporation secondary reserve pre-payment	997,723	972,155
Federal Home Loan Bank stock, at cost (Note 4)	2,073,400	1,291,700
Accrued interest receivable	843,874	736,453
Other assets	635,840	283,100
	<u>\$154,393,594</u>	<u>\$138,466,026</u>

The accompanying notes are an integral part of the financial statements.

Loan Association Financial Condition

<i>Liabilities and stockholders' equity</i>	<i>September 30</i>	
	<i>19X7</i>	<i>19X6</i>
Savings accounts (Note 3)	\$119,162,437	\$114,532,863
Advances from Federal Home Loan Bank (Note 4)	24,880,000	13,500,000
Other borrowed money (Note 5)	1,361,615	2,800,000
Advances from borrowers for taxes and insurance	701,141	677,576
Federal income taxes (Note 7)		
Current	36,300	29,000
Deferred	234,700	187,000
Other liabilities	2,295,585	1,144,700
Total liabilities	<u>148,671,778</u>	<u>132,871,139</u>
Stockholders' equity		
Capital stock—\$1 par value, 500,000 shares authorized; 297,340 shares issued and outstanding	297,340	297,340
Additional paid-in capital	148,670	148,670
Retained earnings—substantially re- stricted (Note 6)	5,321,956	5,148,877
Net unrealized loss on marketable equity securities (Note 1)	<u>(46,150)</u>	<u>—</u>
Total stockholders' equity	<u>5,721,816</u>	<u>5,594,887</u>
Commitments (Note 9)		
	<u>\$154,393,594</u>	<u>\$138,466,026</u>

Stock Savings and Loan Association

Statements of Operations

	<i>Years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Income		
Interest on loans	\$ 9,573,300	\$ 8,164,016
Loan fees	687,413	503,279
Interest and dividends on investments	493,840	425,654
Gain (loss) on sales of investments, net	37,250	(\$14,919)
Gain (loss) on sales of loans, net	(63,717)	27,469
Other	<u>66,285</u>	<u>66,028</u>
Total income	10,794,371	9,171,527
Expenses		
Interest on savings accounts	7,006,533	6,048,663
Interest on advances and other bor- rowing	<u>1,512,508</u>	<u>776,880</u>
	8,519,041	6,825,543
Less interest capitalized	<u>(98,000)</u>	<u>(71,000)</u>
	8,421,041	6,754,543
General and administrative expenses —Notes 8 and 9	1,404,635	1,323,625
Loss provisions and expenses of loans and real estate owned, net	187,769	176,077
Other	<u>519,847</u>	<u>461,778</u>
Total expenses	<u>10,533,292</u>	<u>8,716,023</u>
Income before provision for federal income taxes	261,079	455,504
Provision for federal income taxes (Notes 6 and 7)		
Current	40,300	29,000
Deferred	<u>47,700</u>	<u>111,000</u>
Total income tax provision	<u>88,000</u>	<u>140,000</u>
Net income	<u>\$ 173,079</u>	<u>\$ 315,504</u>
Earnings per share (based on weighted average number of shares outstanding)	<u>\$.58</u>	<u>\$ 1.06</u>

The accompanying notes are an integral part of the financial statements.

Stock Savings and Loan Association **Statements of Stockholders' Equity**

For the years ended September 30, 19X7 and 19X6

	<i>Capital stock</i>	<i>Additional paid-in capital</i>	<i>Retained earnings</i>	<i>Valuation reserve</i>	<i>Total stockholders' equity</i>
Balance October 1, 19X5	\$297,340	\$148,670	\$4,833,373	\$ —	\$5,279,383
Net income for the year ended September 30, 19X6	—	—	315,504	—	315,504
Balance September 30, 19X6	297,340	148,670	5,148,877	—	5,594,887
Net income for the year ended September 30, 19X7	—	—	173,079	—	173,079
Unrealized loss on marketable equity securities	—	—	—	(46,150)	(46,150)
Balance September 30, 19X7	<u>\$297,340</u>	<u>\$148,670</u>	<u>\$5,321,956</u>	<u>\$ (46,150)</u>	<u>\$5,721,816</u>

The accompanying notes are an integral part of the financial statements.

Stock Savings and Statements of Changes

	<i>Years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Sources of funds		
From operations		
Net income	\$ 173,079	\$ 315,504
Add (deduct) items not affecting funds:		
Provision for losses on loans and real estate	93,000	79,517
Provision for depreciation and amortization	224,836	219,508
Other—net	<u>(30,717)</u>	<u>74,474</u>
Funds provided from operations	460,198	689,003
Decrease in cash	1,187,634	—
Decrease in investment securities	150,078	403,758
Loan principal repayments	21,575,117	18,079,581
Cost of		
Sales of participating interests in loans	2,017,131	3,493,227
Sale of real estate acquired in settlement of loans	704,497	1,605,142
Sale of real estate acquired for development	609,385	207,142
Interest credited to savings accounts	4,904,573	4,294,551
Advances from Federal Home Loan Bank	11,380,000	14,500,000
Increase in advances from borrowers for taxes and insurance	23,565	72,413
Additions of other borrowings	400,000	—
Other	<u>552,060</u>	<u>245,718</u>
	<u><u>\$43,964,238</u></u>	<u><u>\$43,590,535</u></u>

The accompanying notes are an integral part of the financial statements.

Loan Association in Financial Position

	<i>Years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Uses of funds		
Increase in cash	\$ —	\$ 1,387,517
Loan disbursements	37,732,239	36,643,270
Purchase of loans and participating interests in loans	1,996,727	2,457,519
Additions to real estate acquired in settlement of loans	344,469	493,056
Additions to real estate acquired for development	542,178	285,330
Purchase of Federal Home Loan Bank stock	781,700	—
Additions to office properties and equipment	494,352	456,695
Net changes in savings account be- fore interest credited	234,188	(1,332,852)
Repayments of advances from Fed- eral Home Loan Bank	—	2,500,000
Repayments of other borrowed money	<u>1,838,385</u>	<u>700,000</u>
	<u><u>\$43,964,238</u></u>	<u><u>\$43,590,535</u></u>

Stock Savings and Loan Association

Notes to Financial Statements

September 30, 19X7 and September 30, 19X6

1. Summary of Significant Accounting Policies

Investment securities. Investment securities, except for marketable equity securities, are stated at cost, adjusted for amortization of premiums, and accretion of discounts on purchase. Marketable equity securities have been stated at the lower of aggregate cost or market. At September 30, 19X6, market exceeded cost on these securities, and, as a result, they were carried at cost. A valuation allowance (reducing the carrying value of investment securities to market) was established at September 30, 19X7, by a charge to stockholders' equity. The amount of this valuation allowance (\$46,150) represents the net unrealized loss on investment securities.

Loan commitment fees. Nonrefundable fees received for commitments to make or purchase loans in the future are deferred to the extent that they exceed the direct costs of underwriting the commitments. For commitments issued to make or purchase loans at market interest rates established at the time the commitments are funded (floating rate commitments), fees in excess of direct underwriting costs are amortized ratably over the commitment period. For commitments issued to make or purchase loans at market rates established at the time the commitments are issued (fixed-rate commitments), fees in excess of direct underwriting costs are amortized over the combined commitment (on the straight-line method) and loan (on the interest method) period. Unamortized fixed-rate commitment fees are recognized as income at the time the loans are made or purchased transactions settled if the market interest rate at such time for similar loans are the same as or lower than the interest rate fixed when the commitment was issued. Nonrefundable commitment fees received for commitments to make loans on existing residences, which are usually funded within approximately 60 days, are amortized to income over the commitment period.

Loan origination fees, discounts, and premiums. The portion of loan origination fees that exceeds the direct costs of underwriting and closing loans is deferred. The deferred fees and discounts received in connection with mortgage loans made and purchased are amortized to income over the average life of mortgage loans, estimated to be ten years, using the interest method. Premiums

on purchased loans are generally amortized over a period of ten years using the interest method.

Unearned income on home improvement and mobile home loans is amortized over the term of loans using the interest method.

Real estate. Real estate is carried at the lower of cost (fair value for real estate acquired in settlement of loans) or net realizable value.

Depreciation. The association computes depreciation and amortization generally on the straight-line method for both financial reporting and federal income tax purposes. The estimated useful lives used to compute depreciation and amortization are building, forty years; equipment, three to fifteen years; and leasehold improvements, over the life of the lease or the life of the improvements, whichever is less.

Allowance for losses. It is the policy of the association to provide valuation allowances for estimated losses on loans and real estate when a significant and permanent decline in value occurs. In providing valuation allowances, costs of holding real estate including the cost of capital are considered. Major loans, real estate owned including development projects, and major lending areas are reviewed periodically to determine potential problems at an early date. The association's experience has shown that foreclosures on loans result in some loss. Therefore, in addition to allowances for specific loans, the association makes a provision for losses on properties based in part on experience and in part on prevailing market conditions. Additions to allowances are charged to earnings.

Income taxes. Deferral of income taxes results primarily from the practice of preparing tax returns on the cash basis of accounting, while the financial statements are prepared on the accrual basis of accounting, and from different methods of accounting for loan fees.

The investment tax credit is accounted for on the flow-through method.

2. Loans Receivable. Loans receivable at September 30, 19X7, and 19X6, consisted of the following.

	<i>September 30</i>	
	<u>19X7</u>	<u>19X6</u>
First mortgage loans	\$135,823,722	\$122,273,578
Insured and GNMA guaranteed loans	3,855,723	1,945,596
Loans to depositors, secured by savings	1,300,338	916,045
Mobile home loans	1,152,920	654,599
Property improvement loans	783,469	620,120
Other loans	56,217	50,822
	<u>142,972,389</u>	<u>126,460,760</u>
Less:		
Undisbursed portion of mortgage loans	6,115,041	5,873,279
Unearned discounts	624,100	512,240
Allowance for losses	98,929	77,640
	<u>\$136,134,319</u>	<u>\$119,997,601</u>

At September 30, 19X7, and 19X6, loans receivable included \$4,000,000 and \$4,200,000, respectively, of loans collateralized by multifamily residential properties the terms of which were modified. Interest on the loans under the original terms would have been approximately \$350,000 and \$375,000 for the years ended September 30, 19X7, and 19X6, respectively. Interest income recorded under the modified terms was \$120,000 and \$100,000, respectively, for the two years. The association is not committed to lend additional funds to debtors whose loans have been modified.

3. *Savings Account Analysis*

	<i>September 30</i>			
	<u>19X7</u>		<u>19X6</u>	
<i>Balances by interest rate</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
5.25% passbook Certificate	<u>\$ 47,664,975</u>	<u>40%</u>	<u>\$ 44,667,817</u>	<u>39%</u>
Accounts:				
5.25 to 5.75%	27,407,361	23	45,813,145	40
5.75 to 6.5%	17,874,366	15	12,598,615	11
6.5% and over	<u>26,215,735</u>	<u>22</u>	<u>11,453,286</u>	<u>10</u>
	<u>71,497,462</u>	<u>60</u>	<u>69,865,046</u>	<u>61</u>
	<u>\$119,162,437</u>	<u>100%</u>	<u>\$114,532,863</u>	<u>100%</u>

4. *Advances From Federal Home Loan Bank.* The advances from the Federal Home Loan Bank consisted of the following:

		<i>September 30</i>	
	<i>Interest rate</i>	<i>19X7</i>	<i>19X6</i>
Due within one year	8½%–9%	\$ —	\$10,500,000
	9%–10%	12,200,000	—
	11½%	3,700,000	—
Other—all due within five years:	7½%–8%	2,500,000	3,000,000
	9%–10%	6,480,000	—
		<u>\$24,880,000</u>	<u>\$13,500,000</u>

These advances are collateralized by Federal Home Bank stock and certain first mortgage loans.

5. *Other Borrowed Money.* Other borrowed money consisted of the following:

		<i>September 30</i>	
		<i>19X7</i>	<i>19X6</i>
9¾% note, due August, 19X7		\$ —	\$1,636,770
10¼% note, due August, 19X8		290,354	—
9% mortgage loan, due October, 19X9		<u>1,071,261</u>	<u>1,163,230</u>
		<u>\$1,361,615</u>	<u>\$2,800,000</u>

The 10¼ percent note is collateralized by investment securities with a carrying value of \$375,000.

The 9 percent mortgage loan is collateralized by lots in a land development project. A principal payment of \$10,000 is required for each lot sold, with any remaining unpaid balance due in October, 19X9.

6. *Retained Earnings.* In connection with the insurance of savings accounts, the association is required to maintain a federal insurance reserve. In addition, the association is subject to the reserve requirements of the state regulatory authorities. These required reserves, which aggregated approximately \$4,050,000 at September 30, 19X7, represent a statutory restriction on retained earnings and cash dividends may not be charged against such reserves. A summary of retained earnings restricted by statutory requirements and the amounts available for payment of cash dividends appears in the table below:

Required statutory reserve	<u>\$4,050,000</u>
Retained earnings available for cash dividends:	
Not subject to federal income taxes	425,000
Subject to federal income taxes, which must be provided at the then current corporate tax rate	<u>847,000</u>
	<u>1,272,000</u>
Retained earnings, September 30, 19X7	<u><u>\$5,322,000</u></u>

Retained earnings at September 30, 19X7, includes approximately \$4,897,000 for which federal income tax has not been provided.

The association is allowed a special bad debt deduction limited generally in the current year to 42 percent (declining to 40 percent in 1979) of otherwise taxable income and subject to certain limitations based on aggregate loans and savings account balances at the end of the year. If the amounts that qualify as deductions for federal income tax purposes are later used for purposes other than for bad debt losses, including distributions in liquidation, they will be subject to federal income tax at the then current corporate rate.

7. Federal Income Tax. Deferred tax expense results from timing differences in the recognition of income and expense for tax and financial reporting purposes. The sources of the differences and the related tax effects were as follows:

	<i>For years ended</i> <i>September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Loan fees recognized for financial reporting purposes when loans are recorded but deferred for tax purposes	\$96,000	\$107,000
Interest capitalized as part of real estate development costs in the financial statements but expensed for tax purposes	98,000	71,000
Income and expenses recognized in the financial statements on the accrual basis but on the cash basis for tax purposes	(99,500)	(6,000)
Other	(17,000)	12,000
Effect of allowable federal tax bad debt deduction applied to above (net of preference tax)	<u>(29,800)</u>	<u>(73,000)</u>
	<u><u>\$47,700</u></u>	<u><u>\$111,000</u></u>

The provision for federal income taxes differs from that computed at the statutory 48 percent corporate tax rate, as follows:

	<i>For years ended September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Tax at statutory rate	\$125,300	\$218,600
Increases (decreases) in taxes resulting from:		
Bad debt deduction based on percentage of income (net of ap- plicable preference tax)	(49,200)	(87,300)
Provisions for loan and real estate losses	25,900	21,800
Other	<u>(14,000)</u>	<u>(13,100)</u>
	<u>\$88,000</u>	<u>\$140,000</u>

8. *Employee Benefits.* The association maintains an insured, contributory pension plan for its employees. The association's policy is to fund pension costs accrued. The total pension expense was \$41,994 in 19X7 and \$46,311 in 19X6 and includes amortization of prior service cost over a twenty-five-year period. The actuarially computed value of vested benefits at January 1, 19X7, the latest valuation date, exceeded the plan assets stated at cost (which approximates market) by approximately \$77,500.

9. *Lease Commitments.* Rental under long-term operating leases for property amounted to \$92,039 in 19X7 and \$56,938 in 19X6. The amounts have been reduced by rental income of \$59,581 in 19X7 and \$59,830 in 19X6 from subleases of one to three years in duration. At September 30, 19X7, the minimum rental commitments under all noncancelable leases with initial or remaining terms of more than one year are as follows:

<i>Years ending September 30</i>	<i>Gross rental expense</i>	<i>Rental income from subleases</i>	<i>Net rental expense</i>
19X8	\$ 151,620	\$33,158	\$ 118,462
19X9	153,695	21,180	132,515
19X0	154,111	4,775	149,336
19X1	154,111	—	154,111
19X2	154,111	—	154,111
Later years	2,568,283	—	<u>2,568,283</u>
Total minimum payments required—net			<u>\$3,276,818</u>

APPENDIX A

Statement of Position

85-2

Accounting for Dollar Repurchase— Dollar Reverse Repurchase Agreements by Sellers-Borrowers

January 1, 1985

**Amendment to
AICPA Audit and Accounting Guide
*Savings and Loan Associations***

**Issued by
Accounting Standards Division**

**American Institute of
Certified Public Accountants**

AICPA

NOTE

This statement of position significantly amends the AICPA Audit and Accounting Guide, *Savings and Loan Associations*, and provides recommendations on accounting principles for dollar repurchase-dollar reverse repurchase agreements by sellers-borrowers for transactions entered into after December 31, 1984.

Statements of position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

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Accounting for Dollar Repurchase – Dollar Reverse Repurchase Agreements by Sellers-Borrowers

Introduction

1. Mortgage financing that is normally collateralized by residential property is generally originated by financial institutions (mortgagees) directly with the purchasers (mortgagors) of the real estate and is referred to as the primary mortgage market. Direct investment in the primary mortgage market by financial institutions, such as savings and loan associations (S&Ls), banks, mortgage banks, and credit unions, may not result in efficient channeling of funds to the housing market because of regional disparities in the supply of and demand for mortgage funds. Consequently, a secondary mortgage market was created through government-related agencies to eliminate regional disparities and provide additional mortgage funds in areas where demand exceeds supply.

2. The Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) have participated in the development and widespread adoption of mortgage-backed securities as a means of financing home loans. Since 1970, the U.S. government has guaranteed, under GNMA sponsorship, timely payments of principal and interest on securities that are issued by private financial institutions and backed by pools of government-insured or government-guaranteed mortgages. GNMA pass-through securities provide for monthly installments of interest on the unpaid balance at the securities' stated certificate rate plus payment of scheduled principal amortization, regardless of the delinquency status of the underlying collateral, together with any prepayment or other recoveries of principal. GNMA pass-through securities are issued by mortgage bankers, S&Ls, and banks that originate FHA-VA mortgages. Instead of selling the mortgages outright or financing them through deposits or other debt, the issuer forms a pool of mortgages, and sells pass-through securities. The issuer collects the mortgage payments and after deducting servicing fees, remits monthly to the certificate holders.

3. Created by Congress in 1970, the FHLMC has as its primary objective the development of a national secondary market in conventional mortgages. Generally, the FHLMC purchases conventional mortgage loans from financial institutions whose deposits are insured by a U.S. government agency. In 1974, it began to sell mortgage participation certificates, which are similar to GNMA pass-through securities, although they are not backed by the full faith and credit of either the U.S. government or the Federal Home Loan Banks. These certificates represent ownership interest in pools of conventional mortgages purchased by the FHLMC. The FHLMC guarantees the monthly pass-through of interest, scheduled amortization of principal, and ultimate repayment of principal. Participation certificates are marketed directly by the FHLMC and by a group of securities dealers who also maintain a secondary market in seasoned issues.

4. GNMA pass-through securities and FHLMC participation certificates are bought and sold in a variety of arrangements, including repurchase–reverse repurchase agreements and dollar repurchase–dollar reverse repurchase agreements.

5. A repurchase–reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back identical certificates within a specified time at a specified price.¹ These transactions are equivalent to borrowing and lending funds equal to the sales price of the related certificates. For example, if an S&L wants to borrow funds with securities as collateral, it may, instead of borrowing, arrange to temporarily sell its certificates with an agreement to repurchase them on a future date at a specified price. A difference in price represents interest for use of the funds.

6. Banks and broker-dealers refer to agreements to sell and repurchase as “repurchase agreements.” S&Ls call these same agreements “reverse repurchase agreements.” Similarly, banks and broker-dealers call agreements to purchase and subsequently sell securities “reverse repurchase agreements,” while S&Ls call such transactions “repurchase agreements.” The following illustrates the use of those terms.

¹For purposes of this statement, the term *certificates* refers only to GNMA pass-through certificates and FHLMC participation certificates. Certain financial institutions, such as S&Ls, consider these certificates investments in real estate loans, while others, such as banks and broker-dealers, consider them to be investments or trading securities.

- A broker-dealer enters into a contract with another broker-dealer to sell and subsequently repurchase the same security. The broker-dealer that sells and repurchases the security calls it a repurchase agreement. The broker-dealer that buys and sells back the security calls it a reverse repurchase agreement.
- An S&L enters into a contract with another S&L to sell and subsequently repurchase the same security. The S&L that sells and repurchases the security calls it a reverse repurchase agreement. The S&L that buys and sells back the security calls it a repurchase agreement.
- An S&L enters into a contract with a bank or broker-dealer to sell and subsequently repurchase the same security. The S&L calls it a reverse repurchase agreement and the bank or broker-dealer also calls it a reverse repurchase agreement.

7. Repurchase–reverse repurchase agreements involve identical securities, and the substance of the transactions is to borrow and lend funds. Dollar repurchase–dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. However, in agreements involving certificates collateralized by dissimilar pools, these transactions would be accounted for as sales and purchases. Due to the increasing complexity and volume of dollar repurchase–dollar reverse repurchase transactions, accounting treatment by the seller-borrower has become increasingly controversial.

8. A dollar repurchase–dollar reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back certificates of the same agency but not the original certificates. Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with certificates having the same stated interest rate as the interest rate stated on the certificates sold. In a yield maintenance agreement, the parties agree that delivery will be made with certificates that will provide the seller a yield that is specified in the agreement. Distinguishing characteristics of each variation are summarized below.

Fixed Coupon

Certificates sold back or delivered bear the identical contract interest rate and similar maturities as the original certificates.

Certificates collateralized by a similar pool of mortgages, such as single-family residential mortgages, and bearing the same contract interest rate are generally priced to result in substantially the same yield.

Fixed coupon agreements do not contain “par cap” provisions.²

Seller-borrower retains control over the future economic benefits relating to the certificate transferred and assumes no additional market risk.

Yield Maintenance

Certificates sold back or delivered may bear a different contract interest rate from the original certificates.

Certificates collateralized by a similar pool of mortgages but bearing a different contract interest rate are not priced to result in substantially the same yield.

The price spread relationship between certificates with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the purchaser to deliver, within the terms of the agreement, certificates providing the greatest benefit to the purchaser.

A yield maintenance agreement may contain a “par cap” provision that could significantly alter the economics of the transaction.

Seller-borrower surrenders control over the future economic benefits relating to the certificate transferred and assumes additional market risk.

9. Believing it desirable to reduce alternative practices in accounting for these agreements, the Accounting Standards Division of the American Institute of Certified Public Accountants has

²A *par cap* is a provision in some yield maintenance agreements limiting the repurchase price to a stipulated percentage of the face amount of the certificate.

prepared this statement of position to clarify the accounting for the sale of securities or borrowing of funds under dollar agreements.

Scope

10. This statement of position applies to accounting for the sale and purchase of securities or borrowing of funds by a fixed coupon or yield maintenance dollar agreement. The recommendations in this statement are limited to transactions involving only GNMA pass-through certificates and FHLMC mortgage participation certificates that the seller-borrower has owned and held in its portfolio for a reasonable period of time, for example, thirty-five days. The recommendations in this statement do not apply to forward placement or delayed delivery contracts for GNMA pass-through certificates or FHLMC mortgage participation certificates or a series of contracts that have the effect of such contracts.³ This statement of position also applies to loans of those certificates if the loans are made under a fixed coupon or yield maintenance dollar agreement. This statement of position does not address accounting and reporting by the purchaser-lender.

11. This statement of position does not supersede existing accounting principles for other types of repurchase–reverse repurchase transactions as set forth in AICPA audit and accounting guides and statements of position.

12. This statement of position sets forth the division's conclusions on —

- Accounting for sales and purchases of or borrowing of funds through GNMA pass-through certificates and FHLMC participation certificates under fixed coupon and yield maintenance dollar agreements.
- Accounting for rollovers and extensions of original agreements.
- Accounting for the repurchase of a principal amount different from the principal amount of the original agreement.

³Accounting for forward placement or delayed delivery contracts is not discussed in this statement of position. An AICPA issues paper, "Accounting for Forward Placement and Standby Commitments and Interest Rate Futures Contracts," was sent to the FASB in December 1980.

Present Accounting Practices

Repurchase—Reverse Repurchase Agreements

13. The 1979 AICPA Audit and Accounting Guide, *Savings and Loan Associations*, addresses repurchases, commonly referred to as *repos*, and concludes that they “represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers will repurchase the securities within a very short period of time, usually a few days.” The S&L guide also concludes that —

In substance, (reverse repurchases or reverse repos) represent borrowings collateralized by the related securities. When funds are borrowed under this (type of) arrangement, a liability should be established for the amount of the proceeds. The investment security account should not be relieved of the collateral securities. Interest on reverse repos should be reported as an expense and not shown net of interest income.

14. The guidance provided in the S&L guide regarding reverse repurchases is consistent with Statement of Financial Accounting Standards (SFAS) No. 65, *Accounting for Certain Mortgage Banking Activities*, paragraph 8, which states —

Mortgage loans and mortgage-backed securities held for sale that are transferred under formal or informal repurchase agreements of the nature described in this paragraph shall (1) be accounted for as collateralized financing arrangements and (2) continue to be reported by the transferor as being held for sale.

Formal and informal agreements are characterized in SFAS No. 65 as those where the risk of market loss is retained by the mortgage banking enterprise. Further support is provided in the AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, which discusses broker-dealer repurchase transactions. The broker-dealer guide defines a repurchase transaction as “a sale of a security coupled with an agreement by the seller to repurchase the same or substantially identical security at a stated price” and states that “securities owned that are sold by the broker or dealer subject to a repurchase agreement are treated as collateral for financing transactions and not as sales.” Banks use the same terminology and account for the transactions in a manner similar to that used by broker-dealers.

Dollar Repurchase–Dollar Reverse Repurchase Agreements

15. Dollar agreements differ from repurchase–reverse repurchase agreements because dollar agreements—

- Are represented by different certificates.
- Are collateralized by different, but similar, mortgage pools, for example, single-family residential mortgages.
- Generally have different principal amounts.

16. Although the AICPA guides and SFAS No. 65 discussed in paragraphs 13 and 14 do not cover dollar agreements specifically, their conclusions appear relevant to dollar repurchase–dollar reverse repurchase agreements. Inherent in the discussions in those guides and SFAS No. 65 is the presumption that the asset (certificate) being “repurchased” is substantially identical in all respects to the asset that was “sold” under the agreement. In a dollar repurchase–dollar reverse repurchase agreement, the certificate that is delivered back may or may not be substantially identical, depending on whether the agreement is a fixed coupon or a yield maintenance dollar agreement.

17. Paragraph 115 of FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, states that “to have an asset, a business must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that benefit by others. . . .” In a dollar repurchase–dollar reverse repurchase agreement, the degree of control over the future economic benefits relating to the asset (certificate) transferred by the seller-borrower depends on whether the certificate delivered back is substantially identical. If the delivered certificate is not substantially identical to the transferred original, the seller-borrower has surrendered control over the future economic benefits relating to the original certificate and has obtained the right to acquire a different asset.

Seller-Borrower

18. The accounting and reporting treatment for the sale of securities or borrowing of funds under dollar agreements varies in practice. Some account for these agreements by relieving the investment securities account of the certificates sold, currently recognizing gains or losses, and recording the purchase of the newly acquired certificates as a separate transaction. Others account for these agreements as a collateralized financing arrangement. The

certificates involved in the transactions are not removed from the investment securities account, gains or losses are not recognized, and a liability is recorded for the amount of the proceeds.

19. The key factor in distinguishing between the sale and purchase of securities and a financing arrangement is the degree of control over the future economic benefits relating to the certificates transferred by the seller-borrower. If the property repurchased is the identical property sold, the seller-borrower has retained control over the future economic benefits relating to the certificates and has assumed no additional market risk, and the transaction is properly accounted for as a financing arrangement. The seller-borrower in a dollar agreement accepts delivery of certificates that are not identical to the certificates used in originating the transaction. The seller-borrower agrees that the repurchased securities are “substantially identical” to those of the original transaction and therefore are “identical” for purposes of consummating the transaction. Inconsistency in practice in defining “substantially identical” securities and in evaluating risk retention has led to the diversity in accounting for dollar transactions.

20. Those supporting the view that fixed coupon dollar agreements are financing arrangements believe that certificates in the GNMA market having similar collateral and bearing the same interest rate are priced to result in substantially similar market values. The rationale is that GNMA certificate prices or yields are quoted to investors based on an assumption of a certain payment level of the pooled mortgages, which results in similar market values. GNMA prices or yields are not quoted to investors on the basis of yield to contractual maturity, that is, what the investor’s return would be if none of the pooled mortgages collateralizing the GNMA certificate was prepaid but paid down in accordance with the contractual amortization schedule. For example, prices or yields of single-family mortgage loan pools are quoted on a basis equivalent to that of a single loan that amortizes according to a prescribed thirty-year amortization schedule with prepayment of the balance in the twelfth year. Although this method does not recognize that different pools of mortgages have varied maturities, it has been accepted and provides a uniform method of quoting prices or yields in the GNMA market.

21. Those supporting the view that fixed coupon dollar agreements are financing arrangements generally agree that fixed coupon

agreements containing a “right of substitution” clause do not involve substantially identical securities because of the inherent uncertainty over the type of securities to be repurchased.⁴ Similarly, they also believe that substantially identical securities are not involved if a fixed coupon dollar agreement gives the buyer-lender the option to deliver back to the seller-borrower a certificate having the same coupon rate but priced to result in a significantly different yield, for example, because of differences in payback experience or maturities. In these instances, transactions would be accounted for as the sale and purchase of securities.

22. Those supporting the view that yield maintenance dollar agreements are sell-buy agreements believe that the purchaser is obligated to deliver or sell back only a certificate with a yield agreed on at the time the transaction originated. Therefore, as noted earlier, the delivered or sold back securities may —

- Bear different certificate interest rates.
- Have different investment principal amounts.
- Possess price spread relationships that do not move in tandem with securities sold.
- Be affected by a “par cap.”

23. Proponents of sell-buy accounting for yield maintenance agreements also believe the cumulative effect of the differences between the original and repurchased certificates is significant enough to preclude such certificates from being considered substantially identical.

Rollovers and Extensions

24. Occasionally, certificates involved in dollar agreements are not delivered at the settlement date of the agreement. Instead, the contract is extended or rolled over at the request of the purchaser or seller. If the original contract is accounted for as a financing arrangement, some believe that a rollover or extension agreement is a separate economic transaction and should be accounted for independently of the original contract. Others view the rollover or extension as merely a continuation of the original contract and do not treat it as a separate economic event for accounting purposes.

⁴A *right-of-substitution clause* is a provision in dollar repurchase–dollar reverse repurchase agreements permitting the buyer to deliver other than substantially identical securities.

Breakage

25. Certificates repurchased commonly have a principal amount that differs from the principal amount of the certificate originally sold under a dollar agreement. This is referred to as *breakage* and occurs because no two GNMA certificates bear the same principal amount as a result of the monthly amortization of the principal balance of mortgages collateralizing the certificate. It is generally accepted in the marketplace that a “good delivery” (one in accordance with the agreement terms) occurs if the principal amount of the certificates repurchased is within 2.5 percent (plus or minus) of the principal amount of the original certificates. Breakage does not present an accounting practice problem for dollar agreements treated as the sale and purchase of securities. The investment account is reduced by the carrying value of certificates sold and increased by the acquisition cost of the certificates purchased.

26. Accounting practice for breakage varies for dollar agreement transactions considered to be financing arrangements. If the principal amount of the delivered certificates is greater than that of the original certificates, there is general agreement that the excess cost represents an additional investment and should be accounted for accordingly. However, if the principal amount of the repurchased certificates is less, the accounting treatment varies.

27. Some make no entry to reflect the reduction in principal amount. This results in a higher cost being assigned to the smaller principal amount of the delivered certificates.

28. Others reflect the reduction in principal by removing a proportionate share of the original certificates, including the pro rata unamortized original premium (discount), from the accounting records and recognizing any gain or loss. This reduces the investment account to a new cost for the repurchased certificates.

Division's Conclusions

29. The Accounting Standards Division believes that yield maintenance agreements do not involve substantially similar securities. Fixed coupon agreements do involve substantially identical securities for purposes of this statement.⁵

⁵The AICPA Committee on Banking is studying the issues relating to the definition of “substantially the same,” and is expected to provide guidance. That guidance should be considered when it is available.

Fixed Coupon

30. Fixed coupon dollar agreements described in this statement of position should be accounted for as collateralized borrowing arrangements (financing) for financial reporting purposes.

31. Accounting for fixed coupon dollar agreements, except as specified in paragraph 32, should be the same as that used for repurchase–reverse repurchase agreements, as described in paragraph 13. A liability should be recorded for the amount of proceeds, and the certificates should not be removed from the accounting records. The difference between selling price and repurchase price should be accounted for as interest cost that is amortized to expense over the term of the agreement and not shown net of interest income. Amortization of original premium (discount) and interest income on the original certificates should continue to be recorded even if there is an exchange of certificates.

32. A fixed coupon agreement that contains a right-of-substitution clause or that provides an option to the buyer-lender to deliver back a certificate priced to result in a significantly different yield should be accounted for in the same manner as a yield maintenance agreement.

Yield Maintenance

33. Yield maintenance dollar agreements should be accounted for as sales with gain or loss recognition⁶ and commitments to purchase securities.

34. A sold certificate, including unamortized premium (discount), should be removed from the accounts and gains or losses recognized at the time of sale. The commitment to repurchase should be disclosed in the notes to the financial statements. The newly acquired investment should be recorded at cost at the time of purchase.

Rollovers and Extensions

35. Rollovers and extensions of dollar agreements should be accounted for based on the facts and circumstances at the time of the rollover or extension; for example, the rollover at maturity of a fixed

⁶If the market value of the securities sold differs from the contract price, the gain or loss should be recognized based on the market value.

coupon dollar agreement into another fixed coupon dollar agreement should be accounted for as a financing arrangement. However, when a fixed coupon dollar agreement is rolled over into another fixed coupon dollar agreement with the same coupon rate at a number of successive maturity dates, or when the period of time from initiation to close is lengthy, for example, more than one year, the seller-borrower may not be receiving the risks and opportunities of ownership of a security substantially identical to that of the original security. These transactions should be accounted for as the completion of a financing arrangement resulting in a sale with gain or loss recognition⁷ and a commitment to purchase securities. The rollover at maturity of a fixed coupon dollar agreement into a yield maintenance dollar agreement results in a new contract. The fixed coupon agreement should be accounted for as the completion of a financing arrangement, and the rollover into a new yield maintenance agreement should be accounted for as a sale with gain or loss recognition⁸ and a commitment to purchase securities.

Breakage

36. If the principal amount of the certificate repurchased in a fixed coupon transaction (financing) is greater than that of those originally sold, the difference should be recorded in the investment account as though a separate acquisition of additional certificates has occurred. If the principal amount is less, the investment account should be relieved of the proportionate share of certificates that have been sold, and gains or losses adjusted for the pro rata share of unamortized premium (discount), should be recognized.

37. Examples of the accounting for dollar agreements are included in the Appendix of this statement.

Effective Date and Transition

38. The conclusions of this statement of position should be applied prospectively to transactions entered into after December 31, 1984. Earlier application is encouraged.

⁷See note 6.

⁸See note 6.

APPENDIX

Examples of Accounting for Dollar Agreements

Fixed Coupon

Accounting by Seller-Borrower

Facts

A financial institution owns an 8 percent GNMA pass-through certificate, pool no. 12345, purchased at 100 (face amount) during November 1977. It agrees to sell this certificate (face amount of \$987,436) on January 15, 1980, at its market value (80) and concurrently agrees to repurchase on May 13, 1980, an 8 percent GNMA pass-through certificate (face amount of \$987,436) at a price of $80^{27/32}$. The seller and buyer agree that “good delivery” of the 8 percent GNMA’s on the repurchase date will occur if the principal amount is within 2.5 percent (plus or minus) of the \$987,436. For the sake of simplicity, this example assumes no pay-down of principal.

January 15, 1980

Cash	\$ 793,021
Interest income on investment in GNMA ($\$987,436 \times 8\% \times 14/360$)	\$ 3,072
Funds borrowed ($\$987,436 \times 80$)	789,949
To record amounts received under dollar agreement and interest earned from January 1, 1980, to January 15, 1980.	

Summary of Monthly Journal Entries Recorded During the 120-Day Agreement Period

Interest expense on funds borrowed ($\$987,436 \times 8\% \times 120/360$)	\$ 26,332
Interest income on investment in GNMA	\$ 26,332
To record normal interest income/expense on 8% GNMA sold under dollar agreement.	
Interest expense on funds borrowed [$\$987,436 \times (80^{27/32} - 80)$]	\$ 8,331
Accrued interest payable	\$ 8,331
To record differential in price as additional interest expense.	

May 13, 1980

Assumption A

Assume return of an 8 percent GNMA pass-through certificate, pool no. 23451, with a current face amount of \$1,004,878 (within the 2.5 percent range for "good delivery"), which is greater than the original principal amount.

Investment in 8% GNMA, pool no. 23451 (new),	
$\$987,436 + [(\$1,004,878 - \$987,436) \times$	
$80^{27/32}]$	\$1,001,537
Accrued interest receivable	
$(\$1,004,878 \times 8\% \times 12/360)$	2,680
Investment in 8% GNMA, pool no. 12345	
(old)	\$987,436
Cash (increment in certificate basis)	
$[(\$14,101) + \text{interest } (\$2,680)]$	16,781
To record additional principal of 8% GNMA, pool no. 23451, and interest earned from May 1, 1980, to May 13, 1980.	

Funds borrowed	\$ 789,949	
Accrued interest payable	8,331	
Cash		\$798,280
To record repayment of funds borrowed.		

Assumption B

Assume return of an 8 percent GNMA pass-through certificate, pool no. 23452, with a current face amount of \$972,625 (within the 2.5 percent range for "good delivery"), which is less than the original principal amount.

Investment in 8% GNMA, pool no. 23452 (new)	\$972,625	
Accrued interest receivable		
$(\$972,625 \times 8\% \times 12/360)$	2,594	
Loss on sale of investment in GNMA,		
8% pool no. 12345 $[\$14,811 \times (100 - 80)]$	2,962	
Funds borrowed	14,811	
Accrued interest payable		
$[14,811 \times (80^{27/32} - 80)]$	124	
Interest income on GNMA investment		
$(\$14,811 \times 8\% \times 120/360)$	396	
Investment in 8% GNMA, pool no. 12345 (old)		\$987,436
Interest expense on funds borrowed (\$124		
+ \$396)		520
Cash		5,556

To record purchase of 8% GNMA, pool no. 23452, sale of 8% GNMA, pool no. 12345, and reduction of funds borrowed on January 15, 1980.

Note: The reduction in basis (\$987,436 - \$972,625 = \$14,811) between the old certificate and the new certificate is used to determine the amount of loss recognition and to adjust the following accounts: funds borrowed, accrued interest, and interest income as established on January 15, 1980, and during the 120-day period ended May 13, 1980.

Funds borrowed (\$789,949 - \$14,811)	\$775,138	
Accrued interest payable (\$8,331 - \$124)	8,207	
Cash		\$783,345
To record repayment of funds borrowed.		

Summary of Cost of Borrowed Funds

Assumption A

Interest on 8% GNMA, pool no. 12345	\$ 26,332
Difference between sale and repurchase price ($80^{27/32} - 80$)	8,331
Total cost of funds	<u>\$ 34,663</u>
Borrowed funds	<u>\$789,949</u>
$\frac{\text{Cost of Funds } (\$ 34,663)}{\text{Borrowed Funds } (\$789,949)} = .044 \times 3 = 13.2\% \text{ annualized}$	

Assumption B

Interest on 8% GNMA, pool no. 12345	\$ 26,332
Difference between sale and repurchase price ($80^{27/32} - 80$)	8,331
Interest expense adjustment due to reduction in basis	(520)
Total cost of funds	<u>\$ 34,143</u>
Initial borrowed funds	\$789,949
Less partial sale of 8% GNMA, pool no. 12345	14,811
Actual borrowed funds	<u>\$775,138</u>
$\frac{\text{Cost of Funds } (\$ 34,143)}{\text{Borrowed Funds } (\$775,138)} = .044 \times 3 = 13.2\% \text{ annualized}$	

Yield Maintenance

Accounting by Seller-Borrower

Facts

A financial institution owns a 9.5 percent GNMA pass-through certificate, pool no. 34621, purchased at 97 during August 1979. It agrees to sell this certificate (face amount of \$992,925) on January 15, 1980, at its market value ($86^{22/32}$) and concurrently agrees to repurchase a 9.5 percent GNMA pass-through certificate (face amount of \$992,925) on May 13, 1980, at 88 to yield 11.34 percent. The seller and buyer agree that "good delivery" of the GNMA's on the repurchase date will occur if the principal amount is within 2.5 percent (plus or minus) of the \$992,925. They further agree that if the FHA or VA mortgage rate changes during the four-month period, the buyer may deliver on the repurchase date a GNMA pass-through certificate bearing the new current interest rate at a price to produce the above yield of 11.34 percent; however, such price shall not exceed par (yield maintenance agreement with a par cap). For the sake of simplicity, this example assumes no pay-down of principal.

January 15, 1980

Cash	\$864,410	
Loss on sale of investment in 9.5% GNMA, pool no. 34621	102,395	
Unearned discount	29,788	
Investment in 9.5% GNMA, pool no. 34621		\$992,925
Interest income on investment in GNMA ($\$992,925 \times 9.5\% \times 14/360$)		3,668
To record sale of 9.5% GNMA, pool no. 34621, in connection with yield maintenance agreement and interest earned from January 1, 1980, to January 15, 1980.		

Note:

Face amount	\$992,925
Cost (97)	963,137
Unearned discount	\$ 29,788
Market January 15, 1980 ($\$992,925 \times 86^{22/32}$)	\$860,742
Loss ($\$963,137 - \$860,742$)	\$102,395

May 13, 1980

Assumption A

Assume the FHA or VA mortgage rate did not change during the four-month period of the agreement and a 9.5 percent GNMA pass-through certificate, pool no. 18960, with a current face amount of \$989,650 (within the 2.5 percent range for “good delivery”) is delivered to the seller-borrower.

Investment in 9.5% GNMA, pool no. 18960	
$(\$989,650 \times 88)$	\$870,892
Accrued interest receivable	
$(\$989,650 \times 9.5\% \times 12/360)$	3,133
Cash	\$874,025
To record purchase of 9.5% GNMA, pool no. 18960, and accrued interest from May 1, 1980, to May 13, 1980.	

Assumption B

Assume the FHA or VA mortgage rate did change during the four-month period of the agreement and delivery is made with an 11 percent (current GNMA interest rate) GNMA pass-through certificate, pool no. 48650, with a current face amount of \$998,875 (within the 2.5 percent range for “good delivery”) priced at $97^{12/32}$ to provide the agreed yield of 11.34 percent.

Investment in 11% GNMA, pool no. 48650	
$(\$998,875 \times 97^{12/32})$	\$972,655
Accrued interest receivable	
$(\$998,875 \times 11\% \times 12/360)$	3,662
Cash	\$976,317
To record purchase of 11% GNMA, pool no. 48650, and accrued interest from May 1, 1980, to May 13, 1980.	

Rollover or Extension

Facts

A financial institution entered a four-month fixed coupon agreement from January 15, 1980, to May 13, 1980. On May 13, 1980, the institution repurchased an 8 percent GNMA pass-through certificate, pool no. 23451, with a face amount of \$1,004,878 and a book basis of \$1,001,537. The institution accounted for the transaction as a financing and recorded journal entries in the manner previously described in this Appendix. Also on May 13, 1980, the institution agrees to sell certificate no. 23451 at its market value (81) and agrees to repurchase an 8 percent GNMA pass-through certificate (current face amount of \$1,004,878) three months later (ninety days) on August 10, 1980.

May 13, 1980

Assumption A — Financing Transaction

Assume a fixed coupon agreement from May 13, 1980, to August 10, 1980.

Cash	\$816,631
Accrued interest receivable	
$(\$1,004,878 \times 8\% \times \frac{12}{360})$	\$ 2,680
Funds borrowed $(\$1,004,878 \times 81)$	813,951
To record amounts received under fixed coupon agreement, 8% GNMA, pool no. 23451, from May 13, 1980, to August 10, 1980, and interest received for the period May 1, 1980, to May 13, 1980.	

Assumption B — Sell-Buy

Assume a yield maintenance agreement from May 13, 1980, to August 10, 1980.

Cash	\$816,631
Loss on sale of investment in 8% GNMA, pool no. 23451 $[\$1,001,537 - (\$1,004,878 \times 81)]$	187,586
Investment in 8% GNMA, pool no. 23451	\$1,001,537
Accrued interest receivable	2,680
To record sale of 8% GNMA, pool no. 23451, in connection with yield maintenance agreement from May 13, 1980, to August 10, 1980, and interest received for the period May 1, 1980, to May 13, 1980.	

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The Savings and Loan Associations Committee gratefully acknowledges the contributions made to the development of this statement of position by Donald A. Zellmer, former chairman of the committee, and Walter E. Erikson, a former member of the committee.

APPENDIX B

Statement of Position

86-1

Reporting Repurchase— Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations

September 30, 1986

**Amendment to
AICPA Audit and Accounting Guide
*Savings and Loan Associations***

**Issued by
Accounting Standards Division**

**American Institute of
Certified Public Accountants**

AICPA

NOTE

This statement of position significantly amends the AICPA Audit and Accounting Guide *Savings and Loan Associations*, and provides recommendations on reporting repurchase–reverse repurchase agreements and mortgage-backed, pass-through certificates by savings and loan associations in financial statements for the year ending on or after September 30, 1986.

Statements of position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

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Reporting Repurchase—Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations

Introduction and Scope

1. In June 1985 a special task force of the Auditing Standards Board of the AICPA issued a report on auditing repurchase agreements entitled *Report of the Special Task Force on Audits of Repurchase Securities Transactions* (hereafter referred to as “the report”). The nonauthoritative report was the result of the task force’s study of the adequacy of existing guidance on auditing transactions involving repurchase and reverse repurchase (RP–RRP) of securities. In part, the report indicates that there is a presumption that the financial statements of entities engaged in these transactions “reflect both the risks of and the returns from those undertakings.”¹ The report also states that “the auditor should evaluate the adequacy of financial statement classification and disclosure of RP–RRP transactions in general and of the status of the collateral in particular.”²

2. The revised edition of the AICPA Audit and Accounting Guide *Savings and Loan Associations* (hereafter referred to as “the S&L guide”) addresses RP–RRP agreements. For repurchase agreements, the S&L guide states that “if material, these investments should be disclosed separately in the financial statements.”³ For reverse repurchase agreements, the S&L guide indicates that a liability should be established for the amount of the proceeds. However, illustrations of disclosures are not provided.

¹American Institute of Certified Public Accountants, *Report of The Special Task Force on Audits of Repurchase Securities Transactions* (New York: AICPA, 1985), 30.

²*Ibid.*, 25.

³American Institute of Certified Public Accountants, *Audit and Accounting Guide Savings and Loan Associations*, 3d rev. ed. (New York: AICPA, 1986), 21. RP–RRP agreements were first addressed in the 1979 revised edition of the S&L guide. The 1986 third revised edition contains the text of the 1979 revised edition plus the above-mentioned *Report of the Special Task Force on Audits of Repurchase Securities Transactions* and Statement of Position 85-2, *Accounting for Dollar Repurchase–Dollar Reverse Repurchase Agreements by Sellers-Borrowers*.

3. Currently, some savings and loan associations disclose RP–RRP agreements separately. However, in the absence of definitive disclosure requirements, the extent of disclosures relating to RP–RRP agreements has differed. The AICPA Savings and Loan Associations Committee (hereafter referred to as “the committee”) believes that specific guidance is needed to achieve uniform reporting practices for transactions involving repurchase and reverse repurchase of securities. Accordingly, this statement of position recommends certain disclosures for RP–RRP agreements, including dollar repurchase–dollar reverse repurchase agreements, by savings and loan associations. In addition, this statement of position modifies the recommended classification of mortgage-backed, pass-through certificates by savings and loan associations as discussed in the S&L guide.

4. The recommendations in this statement of position are limited to RP–RRP transactions by savings and loan associations involving securities as described in paragraph 6. The statement of position does not address reporting for retail repurchase agreements.⁴

Background

Repurchase and Reverse Repurchase Agreements

5. The S&L guide addresses RP–RRP transactions and states the following:

An association may invest in short-term repurchase agreements, commonly referred to as “repos.” These transactions represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers will repurchase the securities within a very short period of time, usually a few days . . .

An association may also borrow under repurchase agreements, commonly referred to as “reverse repos.” In substance, these arrangements represent borrowings collateralized by the related securities.⁵

⁴Institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) are permitted to offer to the public *retail repurchase agreements* in amounts of less than \$100,000 and with maturities of less than ninety days. A retail repurchase agreement is an obligation on the part of the issuing institution to pay a sum of money to the purchaser, secured by a perfected security interest in direct obligations of, or obligations fully guaranteed by, the U.S. government or an agency of the U.S. government.

⁵S&L guide, 21–22.

RP-RRP transactions sometimes take the form of dollar repurchase-dollar reverse repurchase agreements. AICPA Statement of Position (SOP) 85-2, *Accounting for Dollar Repurchase-Dollar Reverse Repurchase Agreements by Sellers-Borrowers*, describes the types of RP-RRP transactions and indicates (in paragraph 7) that RP-RRP agreements involve identical securities whereas dollar repurchase-dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities.

6. The report identifies several uses for RP-RRP agreements—as short-term investments or loans, as a means of borrowing funds for additional investment, or as a means of financing the purchase of government securities.⁶ Most RP-RRP agreements are contracts for the sale and purchase of U.S. Treasury bonds, bills, and notes. However, the agreements may also be contracts for the sale and purchase of mortgage-backed certificates, bankers' acceptances, negotiable certificates of deposit, and commercial paper. Savings and loan associations' transactions in RP-RRP agreements generally involve U.S. Treasury bonds, bills, and notes, as well as mortgage-backed certificates.

Mortgage-Backed Certificates

7. SOP 85-2 (paragraphs 1 through 3) describes the establishment of the secondary mortgage market through the development and adoption of mortgage-backed securities. Several organizations, such as the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA), guarantee privately issued securities backed by pools of government-insured or government-guaranteed mortgages.

8. Under GNMA sponsorship, for example, the U.S. government guarantees timely payments of principal and interest on securities that are issued by private financial institutions and backed by

⁶Report, 4-5.

pools of government-insured or government-guaranteed mortgages. GNMA pass-through securities provide for monthly installments of interest on the unpaid balance at the securities' stated certificate rate, plus payment of scheduled principal amortization, regardless of the delinquency status of the underlying collateral, together with any prepayment or other recoveries of principal. GNMA pass-through securities are issued by mortgage bankers, savings and loan associations, and banks that originate Federal Housing Administration–Veterans Administration (FHA–VA) mortgages. Instead of selling the mortgages outright or financing them through deposits or other debt, the issuer forms a pool of mortgages and sells pass-through securities. The issuer collects the mortgage payments and, after deducting servicing fees, remits monthly to the certificate holders.

9. SOP 85-2, paragraph 4, indicates that mortgage-backed, pass-through securities are bought and sold in several arrangements, including RP–RRP agreements and dollar repurchase–dollar reverse repurchase agreements.

10. The S&L guide states the following:

Investments in pass-through certificates have some characteristics common to investment securities; however, they more closely approximate a participating interest in real estate loans. Accordingly, an investing association should account for those investments in a manner consistent with other participating interests in real estate loans.⁷

Current Reporting Guidance

Repurchase and Reverse Repurchase Agreements

11. Banks, broker-dealers in securities, credit unions, investment companies, and state and local governmental units, as well as savings and loan associations, engage in RP–RRP transactions.⁸ The current reporting practices of some of these entities for RP–RRP transactions are considered in the following discussion.

⁷S&L guide, 23.

⁸Banks and broker-dealers refer to agreements to sell and repurchase as “repurchase agreements.” Savings and loan associations call these same agreements “reverse repurchase agreements.” Similarly, banks and broker-dealers call agreements to purchase and subsequently sell securities “reverse repurchase agreements,” whereas savings and loan associations call such transactions “repurchase agreements.”

12. *Banks.* Banks may invest excess funds by buying U.S. government securities from a borrowing bank or a dealer in U.S. securities. The 1983 AICPA Industry Audit Guide *Audits of Banks* (hereafter referred to as the “bank audit guide”) states that “federal funds transactions should be stated gross rather than net in the balance sheet, as are securities sold or purchased subject to repo or reverse repo agreements that qualify as short-term loans or borrowings.”⁹ The illustrative financial statements contained in the bank audit guide report the carrying amount of investment securities pledged to secure public deposits and “securities sold under agreements to repurchase” in the investment securities note.

13. *Broker-dealers.* The 1985 AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* indicates that securities owned by the broker or dealer that are sold subject to a repurchase agreement are reported with trading and investment accounts, at market value, with the amount of the repurchase agreement reflected as a liability. The purchase of securities at a specified price with an agreement to resell the same or substantially identical securities at a definite price at a specified future date is treated as a receivable collateralized by the securities purchased.¹⁰ The illustrative financial statements in the broker-dealer audit and accounting guide report the market value of the securities sold under agreements to repurchase and the average effective interest rate at year-end on the transactions.

14. *Credit unions.* The 1986 AICPA Audit and Accounting Guide *Audits of Credit Unions* indicates that amounts borrowed under reverse repurchase agreements should be presented separately in the liability section of the statement of financial condition if the amounts are material. Interest rates, due dates, and pledged collateral are among the items that should be disclosed in the notes to the financial statements regarding borrowed funds.¹¹

15. *Savings and loan associations.* For repurchase agreements, the S&L guide states the following: “If material, these

⁹American Institute of Certified Public Accountants, Industry Audit Guide *Audits of Banks* (New York: AICPA, 1983), 68.

¹⁰American Institute of Certified Public Accountants, Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, rev. ed. (New York: AICPA, 1985), 10.

¹¹American Institute of Certified Public Accountants, Audit and Accounting Guide *Audits of Credit Unions* (New York: AICPA, 1986), 59–60.

investments should be disclosed separately in the financial statements.”¹² For reverse repurchase agreements, the S&L guide indicates that a liability should be established for the amount of the proceeds. The S&L guide does not provide any recommendations for disclosure of RP–RRP agreements.

16. *Other.* An exposure draft of a proposed audit and accounting guide for investment companies discusses RP–RRP agreements and provides recommendations for disclosure of those agreements in the financial statements. Also, in January 1986 the Securities and Exchange Commission (SEC) released rules amending the disclosure requirements of Regulation S-X to require disclosure of the nature and extent of SEC registrants’ RP–RRP agreements and the degree of risk involved in those transactions. Finally, in April 1986, the Governmental Accounting Standards Board issued Statement No. 3, *Deposits With Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*.

Views on Additional Disclosure by Savings and Loan Associations

Repurchase and Reverse Repurchase Agreements

17. Currently, other entities that engage in RP–RRP transactions disclose a variety of information about those transactions in the financial statements or in the notes to the financial statements. The committee recognizes that savings and loan associations can look to those reporting practices for guidance. However, the committee believes it should provide specific guidance for savings and loan associations to achieve uniform reporting practices and enhance comparability.

18. The report identified several risks related to RP–RRP agreements:

- Business risk
- Market risk
- Credit risk
- Risk of collateral loss¹³

¹²S&L guide, 21.

¹³Report, 17–20.

19. The report describes business risk as the risk that a party entering into RP–RRP agreements will misunderstand the terms of the agreements. Consequently, the party may misunderstand the economics of the transactions and incorrectly assess the risks it is in fact assuming, the return it hopes to earn, or the financing costs it is incurring.

20. Price changes or market risk may affect the ability of one party to an agreement to continue to finance it and the ability of the other party to repurchase the securities at the maturity of the agreement. Changes in prices also affect the margin in a transaction (the “haircut”); this may create a need for the seller-borrower to transfer additional securities or return cash.

21. The report states that credit risk is the risk that a borrower may not be able to repay a loan. RP–RRP agreements can be viewed as a loan of cash by one party and a loan of securities by another. At maturity, both “loans” are “repaid.” There is a risk that the buyer-lender, having sold or otherwise transferred the securities to third parties, will not have sufficient resources at the maturity of the agreement to obtain the securities required for resale to the seller-borrower. There is also a risk that the seller-borrower will not have sufficient funds to repay the loan (repurchase the securities). Thus, credit risk is faced by both parties to the transaction.

22. Finally, when a seller-borrower transfers securities to a securities dealer under a reverse repurchase agreement, there is a risk of collateral loss; that is, the dealer may not be able to sell the securities back at the agreed-upon price. The report indicates that if the seller-borrower has the legal right to set off the securities against the borrowed funds, the potential economic loss is limited; the loss is then the excess of the market value of the securities (plus accrued interest) at the date of the sale over the amount borrowed, plus or minus any change in that market value and accrued interest.¹⁴ In that case, the risk of losing the collateral is essentially the same as market and credit risk.

23. If a buyer-lender, under a repurchase agreement with a securities dealer, does not perfect a security interest in securities purchased (for example, by having a signed agreement and by taking

¹⁴The accounting loss may be greater or less than the economic loss if the book value of the securities is above or below their market value.

possession either directly or through a custodian acting as its agent), the potential economic loss is the amount advanced plus accrued interest, and the risk assumed becomes that of an unsecured lender, namely, credit risk. Collateral risk for the buyer-lender is reduced if definitive collateral is held by the dealer's custodian as the dealer's agent with specific identification of the assignee or if book entry collateral is transferred directly or by a notation entry. Collateral risk is reduced further if the buyer-lender or its agent, which could be the dealer's bank acting as the lender's agent, takes possession of the collateral.

24. The legal considerations involved in RP-RRP agreements are important when evaluating the risk of collateral loss. The report states the following:

A buyer-lender in an RP-RRP transaction does not automatically obtain a perfected security interest in the underlying securities. . . . To create a valid security interest under the Uniform Commercial Code, the safest approach is to have a separate signed agreement specifically creating the security interest and to perfect the security interest, normally by possession of the collateral.* Some RP-RRP participants provide explicitly in their agreements for security interests that would have standing as such under the Uniform Commercial Code. More commonly, however, RP-RRP transactions do not create security interests; instead, they involve only a pair of matched confirmations that are similar to an initial purchase or sale transaction coupled with a forward contract that will reverse the first transaction at a price that provides for the payment to the buyer-lender of what is, in effect, interest.

. . .

*The Uniform Commercial Code has been enacted, with some variations, in all states except Louisiana. Article 8 of the model code, which deals with investment securities, was revised in 1977 to cover, among other things, book entry securities, but only some states adopted the revisions. In those that did, a security interest may be created and perfected in several ways, none of which requires the filing of a formal notice. Even if a security interest has not been created and perfected, the courts may choose, for one reason or another, to recognize a particular RP-RRP agreement as a secured loan. Currently, ongoing litigation concerning Bevill, Bresler & Schulman Asset Management Corp., E. S. M. Government Securities, Inc., and other dealers may yield judicial precedents on what is required to perfect a security interest under the Uniform Commercial Code. Moreover, questions have been raised as to whether implications could be drawn from relevant U.S. Treasury regulations that would cast doubt on the applicability of the 1977 revisions to the Uniform Commercial Code as they apply to U.S. government securities. As suggested in a later section of this report, auditors should consider whether an opinion from the client's legal counsel should be obtained regarding the status of the securities underlying an RP-RRP transaction.

Possession of the underlying securities may be obtained either directly by the buyer-lender or indirectly through a third party that, acting as the buyer-lender's agent, takes possession of and holds the securities for the exclusive use of the buyer-lender. Such a custody agreement should be evidenced in writing for the buyer-lender's protection, and the custodian should be required to specifically identify and segregate the securities held for the buyer-lender.

. . .

Government securities dealers, but not certain financial institutions such as commercial banks and savings and loan associations, are subject to the Bankruptcy Code. The FHLBB [Federal Home Loan Bank Board] in October 1984 indicated that its policy, in cases in which the Federal Savings and Loan Insurance Corporation (FSLIC) was the receiver of an insured institution, was not to limit the contractual rights of the buyer-lender to sell securities underlying repurchase agreements except in cases of fraud or other extraordinary circumstances. Similar action has not been taken, however, by the FDIC [Federal Deposit Insurance Corporation], but its practices have been consistent with those formally adopted by the FHLBB. The powers of receivers and conservators of bankrupt institutions that are not subject to the Bankruptcy Code are governed by many differing federal and state statutes and regulations. Accordingly, the rights of each party to the underlying securities in case of insolvency may not always be treated by the courts in the manner specified in the particular RP-RRP agreement (or master agreement). Nevertheless, those agreements should contain language that defines what each party intends its rights to be.¹⁵

25. The report states that there is "a presumption that the financial statements reflect both the risks of and the returns from those undertakings. . . ."¹⁶ Further, the report states that "conceptually, the nature of, and the risks involved in, an RP-RRP agreement may affect the classification and valuation of accounts reported on the face of the financial statements or the disclosures reported in the notes thereto. . . . Because of such matters as the right to return similar but not the same collateral and the variation in the length of the agreement (possibly to the maturity of the security), difficult judgments must be made by financial statement preparers regarding their substance."¹⁷ The report recommends that "the appropriate

¹⁵Report, 12-14. For further discussion on the legal considerations of RP-RRP agreements and the underlying securities, see these pages of the report.

¹⁶*Ibid.*, 30.

¹⁷*Ibid.*, 30-31.

accounting standard-setting bodies should consider requiring disclosure information to assist users in assessing the risks assumed in RP-RRP agreements and of the amounts by which both the carrying value and the market value of the underlying securities in those agreements exceed the cash proceeds.”¹⁸ The committee concurs with this recommendation, believing that a combination of disclosures will provide readers of an association’s financial statements with the information necessary to assess the association’s position with respect to the various risks.

26. For example, disclosure of the market value of the securities underlying the agreements, coupled with the description of the association’s method for handling the collateral, provides the reader with information to assess the potential economic and accounting loss in the event that the transactions are not completed according to their terms. Volume and rate data on reverse repurchase agreements provide information on the association’s method and cost of funding. Volume data also supply information on the amount of exposure under reverse repurchase agreements during the period as well as at the end of the period.

27. The report also states that the “auditor’s proper role is to evaluate whether . . . disclosures reflect the substance of RP-RRP transactions and are in other respects in conformity with generally accepted accounting principles.”¹⁹ The committee believes additional guidance on reporting RP-RRP transactions for savings and loan associations will assist the auditor in that role.

Mortgage-Backed Certificates

28. Many RP-RRP agreements by savings and loan associations involve mortgage-backed, pass-through securities. The S&L guide states that “such securities provide a means for associations to invest available funds in easily transferable packages of real estate loans or to sell such packages to generate needed cash.”²⁰ Thus, mortgage-backed certificates provide savings and loan associations with a more liquid, marketable investment than the underlying mortgage loans.

¹⁸Ibid., 31.

¹⁹Ibid.

²⁰S&L guide, 22.

Mortgage-backed certificates traditionally have been included in loans receivable in the financial statements. However, some savings and loan associations classify mortgage-backed certificates separately from loans receivable in recognition of the above characteristics.

29. Statement of Financial Accounting Standards (SFAS) No. 65, *Accounting for Certain Mortgage Banking Activities*, establishes accounting and reporting standards for certain mortgage banking activities. Mortgage-backed, pass-through certificates held for sale by mortgage bankers, as well as by banks and by savings and loan associations that conduct operations substantially similar to the primary operations of mortgage bankers, are reported at the lower of cost or market value, determined as of the balance sheet date. Paragraph 9 of SFAS No. 65 provides guidance for determining the market value of mortgage-backed certificates. Paragraph 28 of SFAS No. 65 states that mortgage banking enterprises shall distinguish between “(a) mortgage loans and mortgage-backed securities held for sale and (b) mortgage loans and mortgage-backed securities held for long-term investment.”

30. The S&L guide recognizes that investments in pass-through certificates have some characteristics common to investment securities. The S&L guide also indicates that the market value of investment securities should be disclosed parenthetically in the financial statements or the notes.²¹ The bank audit guide discusses the importance of market value information.

Disclosure of the market value of investment securities, in either the balance sheet or the notes to the financial statements, helps a reader of a bank's financial statements to evaluate the potential earning power of those investments, since the potential earning power is governed by prevailing market interest rates applied to the estimated market value and not the book value of the bank's invested assets. Disclosure of the market value is required.²²

Some savings and loan associations currently report the market value of mortgage-backed certificates. The committee believes the

²¹*Ibid.*, 20.

²²Bank audit guide, 34.

market value of mortgage-backed certificates provides important information to the users of an association's financial statements.

Recommendations

31. The AICPA Savings and Loan Associations Committee recommends the following.

Repurchase and Reverse Repurchase Agreements

The following should be disclosed in the financial statements or in the notes to the financial statements.

- a.* Disclosures for the end of the period:
1. Securities purchased under agreements to resell (repurchase agreements), including—
 - A description of the securities underlying the agreements
 - The cost of the agreements, including accrued interest
 - The market value of the securities underlying any agreement if less than the cost of that agreement
 - The maturity of the agreements
 - The dollar amount of agreements to resell the same securities
 - The dollar amount of agreements to resell substantially identical securities
 - Any material concentrations at the end of the period.²³ If any material concentrations exist at the end of the period, disclosure should be made of the association's

²³"Material concentration" refers to the dollar amount of assets at risk under agreements outstanding at the report date with any one dealer. "Assets at risk" is defined as the amount of funds advanced plus accrued interest if the securities underlying the agreements are not in the possession of the association or its agent. If the securities underlying the agreements are in the possession of the association or its agent, assets at risk is defined as the amount of funds advanced plus accrued interest less the market value of the securities underlying the agreements if less than cost. Materiality should be considered in relation to the association's net worth as well as to its operations.

control of the securities underlying the agreements.²⁴ If concentrations at the end of the period vary from those during the period, consideration should be given to disclosing this information.

2. Securities sold under agreements to repurchase (reverse repurchase agreements), including—
 - A description of the securities underlying the agreements
 - The book value, including accrued interest of the securities underlying the agreements
 - The market value of the securities underlying the agreements
 - The maturity of the agreements
 - The weighted-average interest rate of the agreements
 - The dollar amount of agreements to repurchase the same securities
 - The dollar amount of agreements to repurchase substantially identical securities
 - Any material concentrations at the end of the period.²⁵ If any material concentrations exist at the end of the

²⁴“Control” refers to the ability of the association to exercise legal authority over the securities that serve as the collateral for the RP–RRP agreement in the event of default by the counterparty. The association has a different loss exposure if it lacks control over the collateral in a repurchase transaction than if it lacks control over the collateral in a reverse repurchase transaction.

Control of the assets underlying a repurchase transaction exists if (1) the association holds the securities that serve as collateral for the agreement and (2) the association, upon default by the counterparty, has the ability to obtain the collateral benefit from those securities. Control may also exist if the association, instead of holding the securities, has the collateral held in the name of or for the benefit of the association by an independent third party, and condition (2) above is met. Lack of control exposes the association to risk of loss of the amount invested.

In a reverse repurchase agreement, the counterparty, for its benefit, usually exercises control over the securities underlying the agreement. The association has a risk exposure to the extent that its assets that serve as the collateral exceed the amount borrowed, including accrued interest.

²⁵“Material concentration” refers to the dollar amount of assets at risk under agreements outstanding at the report date with any one dealer. “Assets at risk” is defined as the book value of securities sold under agreements to repurchase, including accrued interest plus any cash or other assets on deposit to secure the repurchase obligation, less the amount borrowed against it (adjusted for accrued interest). Materiality should be considered in relation to the association’s net worth as well as to its operations.

period, disclosure should be made of the association's control of the securities underlying the agreements.²⁶

If concentrations at the end of the period vary from those during the period, consideration should be given to disclosing this information.

- b.* Disclosures for RP–RRP agreements during the period:
 - 1. The maximum amount of outstanding agreements at any month-end during the period
 - 2. The average amount of outstanding agreements for the period
 - 3. A statement of whether the securities underlying the agreements were under the association's control

Mortgage-Backed, Pass-Through Certificates

Investments in mortgage-backed, pass-through certificates should be reported separately in the statement of financial condition. The market value of the mortgage-backed, pass-through certificates should be disclosed in the statement of financial condition or in the notes to the financial statements.

32. The appendix to this statement of position provides illustrations of these disclosures.

Effective Date and Transition

33. The recommendations in this statement of position should be applied to financial statements for the year ending on or after September 30, 1986. Earlier application is encouraged.

²⁶See note 24.

APPENDIX

Illustrative Financial Statement Disclosures

This appendix contains illustrations of the disclosures in the financial statements of savings and loan associations recommended in the statement of position. The appendix amends the illustrative financial statements contained in the revised edition of the Audit and Accounting Guide *Savings and Loan Associations*. The following disclosures are illustrative and other formats are acceptable.

Stock Savings and Loan Association
Statements of Financial Condition*

<u>Assets</u>	<u>September 30</u>	
	<u>19X7</u>	<u>19X6</u>
Cash (including certificates of deposit of \$1,300,000 (19X7) and \$2,400,000 (19X6))	\$ 1,563,478	\$ 2,751,112
Securities purchased under agreements to resell (Note X)	XXXX	XXXX
Investment securities (Notes 5 and Y)		
U.S. government (including agencies)		
Market value \$2,346,000 (19X7) and \$2,141,000 (19X6)	2,400,100	2,200,038
Municipals		
Market value \$1,970,000 (19X7) and \$2,474,000 (19X6)	2,125,008	2,565,093
Other		
Securities carried at market in 19X7 and at cost in 19X6 (cost in 19X7 of \$411,150; market in 19X6 of \$283,000)	365,000	275,055
Mortgage-backed certificates, market value XXXX (XXXX at 19X6) (Note Y)	XXXX	XXXX
Loans receivable, net (Notes 2 and 4)	136,134,319	119,997,601
Real estate		
Acquired in settlement of loans less allowance for losses of \$85,566 (19X7) and \$70,141 (19X6)	1,101,238	1,423,676
Acquired for development (Note 5)	1,119,578	1,176,295
Office properties and equipment, at cost, less accumulated depreciation of \$1,127,888 (19X7) and \$1,006,424 (19X6)	5,034,036	4,793,748
Federal Savings and Loan Insurance Corporation secondary reserve prepayment	997,723	972,155
Federal Home Loan Bank stock, at cost (Note 4)	2,073,400	1,291,700
Accrued interest receivable	843,874	736,453
Other assets	635,840	283,100
	<u>\$154,393,594</u>	<u>\$138,466,026</u>

The accompanying notes are an integral part of the financial statements.

<u>Liabilities and stockholders' equity</u>	<u>September 30</u>	
	<u>19X7</u>	<u>19X6</u>
Savings accounts (Note 3)	\$119,162,437	\$114,532,863
Advances from Federal Home Loan Bank (Note 4)	24,880,000	13,500,000
Securities sold under agreements to repurchase (Note Y)	XXXX	XXXX
Other borrowed money (Note 5)	1,361,615	2,800,000
Advances from borrowers for taxes and insurance	701,141	677,576
Federal income taxes (Note 7)		
Current	36,300	29,000
Deferred	234,700	187,000
Other liabilities	<u>2,295,585</u>	<u>1,144,700</u>
Total liabilities	<u>148,671,778</u>	<u>132,871,139</u>
Stockholders' equity		
Capital stock—\$1 par value, 500,000 shares authorized; 297,340 shares issued and outstanding	297,340	297,340
Additional paid-in capital	148,670	148,670
Retained earnings—substantially restricted (Note 6)	5,321,956	5,148,877
Net unrealized loss on marketable equity securities (Note 1)	<u>(46,150)</u>	<u>—</u>
Total stockholders' equity	<u>5,721,816</u>	<u>5,594,887</u>
Commitments (Note 9)		
	<u><u>\$154,393,594</u></u>	<u><u>\$138,466,026</u></u>

*These sample financial statements from pages 98 to 109 of the revised edition of the Audit and Accounting Guide *Savings and Loan Associations* have not been revised for other disclosures currently required under generally accepted accounting principles. They are presented here only to illustrate the disclosures recommended in the statement of position. The committee is currently revising the S&L guide, and the sample financial statements contained in the updated guide should be reviewed when it is available.

Notes to Financial Statements

Note X. Securities Purchased Under Agreements to Resell

	<u>September 30</u>	
	<u>19X7</u>	<u>19X6</u>
Securities purchased under agreements to resell, including accrued interest		
Mortgage-backed certificates with a market value of XXXX (XXXX at 19X6)	XXXX	XXXX
U.S. government securities with a market value of XXXX (XXXX at 19X6)	<u>XXXX</u>	<u>XXXX</u>
	<u>XXXX</u>	<u>XXXX</u>

The association enters into purchases of securities under agreements to resell (repurchase agreements). The amounts advanced under these agreements represent short-term loans and are reflected as a receivable in the statement of financial condition. The securities underlying the agreements are book entry securities. During the period, the securities were delivered by appropriate entry into the association's account maintained at the Federal Reserve Bank of New York (or MBS Clearing Corporation for GNMA securities) or into a third-party custodian's account designated by the association under a written custodial agreement that explicitly recognizes the association's interest in the securities. At September 30, 19X7, these agreements matured within ninety days. The agreements relating to mortgage-backed certificates were agreements to resell substantially identical securities. At September 30, 19X7, no material amount of agreements to resell securities purchased was outstanding with any individual dealer. Securities purchased under agreements to resell averaged XXXX and XXXX during 19X7 and 19X6, and the maximum amounts outstanding at any month-end during 19X7 and 19X6 were XXXX and XXXX, respectively.

Note Y. Securities Sold Under Agreements to Repurchase

	<i>September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Securities sold under agreements to repurchase		
Mortgage-backed certificates with a book value including accrued interest of XXXX (XXXX at 19X6) and a market value of XXXX (XXXX at 19X6)	XXXX	XXXX
U.S. government securities with a book value including accrued interest of XXXX (XXXX in 19X6) and a market value of XXXX (XXXX at 19X6)	<u>XXXX</u>	<u>XXXX</u>
	<u>XXXX</u>	<u>XXXX</u>

The association enters into sales of securities under agreements to repurchase (reverse repurchase agreements). Fixed-coupon reverse repurchase agreements are treated as financings, and the obligations to repurchase securities sold are reflected as a liability in the statement of financial condition. The dollar amount of securities underlying the agreements remains in the asset accounts. The securities underlying the agreements are book entry securities. During the period, the securities were delivered by appropriate entry into the counterparties' accounts maintained at the Federal Reserve Bank of New York (or MBS Clearing Corporation for GNMA securities). At September 30, 19X7, these agreements had a weighted-average interest rate of 8.92 percent (9.23 percent at September 30, 19X6) and matured within one year. * At September 30, 19X7, XXXX of the agreements relating to mortgage-backed certificates were agreements to repurchase substantially identical securities. At September 30, 19X7, XXXX of the agreements involving mortgage-backed certificates with a book value of XXXX and a market value of XXXX were transacted with one primary dealer. The mortgage-backed certificates underlying the agreements were delivered to the dealers who arranged the transactions. The dealers may have sold, loaned, or otherwise disposed of such securities to other parties

*A tabular presentation of maturities would also be acceptable.

in the normal course of their operations, and have agreed to resell to the association substantially identical securities at the maturities of the agreements. Securities sold under agreements to repurchase averaged XXXX and XXXX during 19X7 and 19X6, and the maximum amounts outstanding at any month-end during 19X7 and 19X6 were XXXX and XXXX, respectively.†

†The association should consider disclosing the average interest rate of the agreements during the period.

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APPENDIX C

Report of the Special Task Force on Audits of Repurchase Securities Transactions

JUNE 1985

American Institute of Certified Public Accountants

NOTICE TO READERS

This report has been prepared by the Auditing Standards Board's Special Task Force on Audits of Repurchase Securities Transactions. The conclusions and recommendations presented are those of the task force members and have not been approved, disapproved, or otherwise acted on by the Auditing Standards Board, the membership, or the governing body of the American Institute of Certified Public Accountants. Therefore, this report is not an official pronouncement of the Institute.

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Preface

Failures in recent years of several unregulated government securities dealers have raised questions about the operation of the government securities markets and about audits of government securities dealers and other participants in government securities transactions. Many of those questions relate to financial instruments called repurchase and reverse repurchase agreements. Recognizing the importance of those questions, the AICPA appointed a special task force to study the adequacy of existing guidance for auditing repurchase and reverse repurchase transactions. This report is the result of the task force's efforts.

The auditing of repurchase and reverse repurchase transactions is of concern to the auditors, managements, and regulators of financial services entities. Accordingly, this report is being widely distributed to those interested parties, including the following:

- AICPA members in practice and industry concerned with financial services industries
- AICPA financial services industries' technical committees
- State society presidents, executive directors, and accounting and auditing committee chairmen
- Financial services industries' membership associations
- Regulatory agencies of financial services industries

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Report of the Special Task Force on Audits of Repurchase Securities Transactions

Introduction

The failures of several unregulated government securities dealers in recent years have resulted in substantial losses to investors, a depositors' run on a number of savings and loan institutions, and repercussions throughout many segments of the economy. Certain of those failures involved financial instruments called repurchase and reverse repurchase (RP-RRP) agreements. RP-RRP agreements involve the purchase of securities with a promise that, at a specified time in the future and at a specified price, the transaction will be reversed—that is, the buyer will sell the securities back to the seller. Because of the reversal feature, the agreements are often not considered to be purchases and sales but are viewed as short-term loans of cash collateralized by securities.

The losses caused by the collapse of several government securities dealers are being attributed principally to the fraudulent concealment of the dealers' financial condition and the misappropriation of investors' collateral. Those losses raised questions about the operation of the government securities markets and about audits of participants in those markets. Some of those questions are—

- Should the segments of the government securities market that are presently unregulated and unmonitored remain so?
- Would further regulation of entities participating in RP-RRP agreements with government securities dealers have limited the losses incurred?
- What is the legal status of RP-RRP agreements, including the status of collateral held by dealers for customers?
- Could the financial statements of the failed dealers have alerted participants to the risks of doing business with those entities?
- What responsibilities should the auditors of the entities that engage in RP-RRP agreements have for alerting the users of those entities' financial statements to the risks connected with particular RP-RRP transactions?
- Are current auditing standards adequate for providing guidance to auditors of entities entering into RP-RRP agreements?

Only the latter three questions are within the direct purview of the accounting profession. Consideration of those questions must recognize the legal and economic environment in which RP-RRP agreements take place, such as—

- The importance of the government securities market in financing the national debt and to the Federal Reserve Board's (FRB) control of the money supply.
- The need to consider the costs of further regulation and the economic incidence and effects of those costs.
- The great variety in the forms of agreements and their maturities, interest rates, collateral security arrangements, and in the types of securities that are incorporated into RP-RRP agreements.
- The difference between the form of the agreement—a sale and repurchase by one entity and a purchase and resale by another—and the underlying intent of the parties to it, which may be to finance an RP-RRP transaction or to make a loan secured through the use of securities as collateral.
- Uncertainties surrounding the legal status of RP-RRP agreements, which can lead to a misunderstanding of the various risks involved.
- The business risk, market risk, credit risk, risk of collateral loss, and control risk that exist in RP-RRP agreements.

Recognizing the importance of the questions related to RP-RRP transactions, the American Institute of Certified Public Accountants appointed the Special Task Force on Audits of Repurchase Securities Transactions to study the adequacy of the existing guidance for auditing those transactions. The task force focused primarily on considering ways in which auditors of entities engaging in RP-RRP agreements with government securities dealers, including components of banks acting in their capacity as dealers, could assess the various risks that those agreements entail. Many of those risks are also applicable to RP-RRP transactions entered into by government securities dealers. Questions raised about the desirability of government regulation of government securities dealers are currently being addressed by the Securities and Exchange Commission (SEC), Congress, and the FRB and are beyond the purview of this report.

Similarly, accounting and reporting issues are discussed in this report only as background to facilitate an understanding of the evolution and use of RP-RRP agreements; resolution of those issues is more appropriately within the purview of accounting standard-setting bodies. The AICPA's Savings and Loan Associations Committee has addressed accounting issues relating to certain types of RP-RRP

agreements in the recently issued Statement of Position (SOP) 85-2, *Accounting for Dollar Repurchase–Dollar Reverse Repurchase Agreements by Sellers-Borrowers*, and the Governmental Accounting Standards Board (GASB) is currently considering guidance to state and local governmental units in its proposed statement *Accounting and Financial Reporting for Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*.¹ Also, the AICPA Accounting Standards Executive Committee appointed the Task Force on Financial Instruments to identify the accounting and financial reporting implications of emerging financial instruments and to review AICPA projects dealing with accounting for those instruments.

Background and Use of Repurchase and Reverse Repurchase Agreements

The evolution of RP-RRP agreements is linked directly to the U.S. Treasury's issuance of large volumes of government securities. The Federal Reserve Bank, which buys and sells government securities in conducting its open market operations to implement its monetary policy, deals solely with thirty-six primary dealers. Those dealers are components of thirteen major banks, twelve diversified brokerage firms, and eleven bond dealers. The primary dealers may hold the securities as investments, resell them to institutional or individual investors, or resell them to other dealers, known as secondary dealers, of which there may be 200 or more. The large publicized losses in recent years resulted from failures among secondary dealers.

Although RP-RRP agreements are written in the form of sales of securities with promises to repurchase them, the transactions are often intended to serve as loans that finance investments. Primary and secondary dealers often use RP-RRP agreements to finance their significant holdings of government securities. Dealers enter into those financing agreements with savings and loan institutions, governmental units, credit unions, pension funds, mutual funds, other institutional investors, and other dealers. The entities that initially remit cash for an interest in securities are called buyer-lenders in this report; the entities that initially receive cash for an interest in securities are called seller-borrowers. A single entity may be both a buyer-lender and a seller-borrower at any given time. While the largest

1. References to and quotations from the GASB proposed statement reflect the June 6, 1985, draft of that document.

segment of the RP-RRP market consists of agreements involving U.S. Treasury bonds, bills, and notes, agreements involving other financial instruments, such as mortgage-backed securities, bankers' acceptances, negotiable certificates of deposit, and commercial paper, are also significant.

While the transactions are referred to as RP-RRP agreements in this report, the task force notes that more often than not they are entered into and completed without formal written agreements; and formal written agreements, when used, take on an almost infinite variety of terms and forms. Most often the only documentation supporting an RP-RRP agreement is a dealer's trade advice. However, some parties refuse to engage in RP-RRP activities without formal and documented approval from a credit committee supported by a master agreement² that sets forth the terms, rights, and obligations of each party.

Use as Investments or Loans

Buyer-lenders generally view RP-RRP agreements as short-term,³ low-risk investments or loans. A buyer-lender transfers cash to a seller-borrower and receives securities (or has securities designated or held on its behalf) as "collateral," and the seller-borrower agrees to take back the securities and repay the cash plus interest at a future date.

For many buyer-lenders, RP-RRP agreements are the shortest term investments or loans available, sometimes as short as one day. The yield is relatively high for such short-term investments and can sometimes be improved further if the buyer-lender agrees not to require delivery of the securities from the seller-borrower. Many entities engaging in RP-RRP transactions as buyer-lenders believe that, because the transactions are generally collateralized by U.S. government securities, they are exposed to little risk of loss in the event of default or bankruptcy of a seller-borrower. Risks relating to market changes and the creditworthiness of the seller-borrower may exist, however, and are discussed below.

For some buyer-lenders, such as state and local governmental units that are prohibited from making certain types of investments,

2. Some RP-RRP transactions are executed under both master repurchase agreements that outline the basic rights and obligations of both the buyer-lender and seller-borrower and under specific repurchase agreements that confirm the terms of specific transactions. The specific agreements incorporate the terms of the master agreement. Buyer-lenders also often enter into agreements with their custodial banks that specify the basic responsibilities of the buyer-lender and the custodians.

3. Short term is generally considered to be from one to thirty days.

RP-RRP agreements having federal government obligations as the underlying security may provide an acceptable form of investment. State and local governmental units prefer to interpret the agreements as purchases and subsequent sales of securities because state law may not specifically permit investments in repurchase agreements and may prohibit loans to private parties. State law usually allows investments in securities that underlie those agreements, which permits the transactions to be interpreted as legal investments.

Use as a Means of Borrowing Funds for Additional Investment

Entities sometimes use RP-RRP agreements to obtain funds for additional investment. In such instances they act as seller-borrowers, transferring securities to buyer-lenders for cash and promising to repay the cash plus interest in exchange for the same or similar securities. The cash obtained in exchange for the securities is reinvested for the term of the RP-RRP agreement, with the expectation that the interest paid on the borrowing will be less than the earnings on the investment.

Use to Finance the Purchase of Government Securities

As previously noted, primary and secondary dealers use RP-RRP agreements to finance their government securities holdings. Other entities may also finance purchases of government securities by entering into RP-RRP agreements. The seller-borrower arranges to transfer the securities, which it may not yet own, to the buyer-lender for the cash needed to buy the securities. Alternatively, the seller-borrower may order the securities from or through the buyer-lender but not take delivery, leaving the securities with the buyer-lender as collateral for the loan of the purchase price. The seller-borrower promises to repay the debt in the future, possibly by allowing the repurchase to lapse or by selling the securities to a third party.

Similarities With Other Types of Transactions

RP-RRP agreements are hybrids, having elements of both buy-sell transactions and collateralized loans. Buyer-lenders in RP-RRP transactions have risks and rewards of ownership that are similar in some respects to those attaching to investments in general. Among those are the right to use or trade the securities during the term of the agreement and to keep any resulting profits; buyer-lenders also incur the risk of any resulting losses.

Many characteristics of RP-RRP agreements make them analogous to collateralized loans. For example, buyer-lenders earn inter-

est on the amount of cash that is exchanged, not on the face or market value of the securities. Also, the interest earned is specified by the terms of the agreements; it is not based on the interest rate specified in the underlying securities. If a seller-borrower defaults on its commitment to repurchase the securities (repay the loan) and the buyer-lender liquidates the underlying securities, any excess of the proceeds over the repurchase price may be returned to the seller-borrower. Furthermore, if the market value of the underlying securities declines, the buyer-lender may have the contractual right to require the seller-borrower to increase the amount of those securities or, alternatively, reduce the amount of the loan.

The terms of a particular RP-RRP transaction determine whether it should be accounted for as a sale or purchase of securities with a commitment to later reverse the transaction, or as a collateralized loan with commitments to repay the loan and return the collateral. Accounting standard-setting bodies have addressed that question in the course of prescribing the appropriate accounting for RP-RRP transactions. A later section of this report notes the accounting measurement and disclosure requirements for those transactions.

Terminology

The government securities industry is replete with specific industry terms and technical jargon. Some of the more frequently used terms are defined and explained below and are used throughout this report. Those seeking greater familiarity with the government securities industry may wish to consult the AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, or industry publications.

Repurchase and Reverse Repurchase Agreements

The GASB explains a basic repurchase agreement in its proposed statement as follows:

State and local governmental entities sometimes invest cash in repurchase agreements with broker-dealers and financial institutions. In a repurchase agreement transaction, the governmental entity (buyer-lender) transfers cash to a broker-dealer or financial institution; the broker-dealer or financial institution (the seller-borrower) transfers securities to the governmental entity and promises to later repay the cash plus interest in exchange for the return of the *same* securities.

The transaction described in the GASB statement is called a repurchase agreement by governmental entities, savings and loan

institutions, and others. When government securities dealers, broker-dealers, and banks acting in their capacity as dealers are buyer-lenders, they refer to agreements to transfer cash, to receive securities, and subsequently to return the securities for cash as reverse repurchase agreements.

The GASB defines a basic reverse repurchase agreement as follows:

State and local governmental entities sometimes enter into reverse repurchase agreements when they want to temporarily convert securities in their portfolios to cash. In this transaction, the entity acts as the seller-borrower, transfers securities to someone else for cash, and promises to later repay cash plus interest in exchange for the return of the *same* securities. The cash obtained in these transactions is often used for operating or capital purposes or reinvested in other securities.

The transaction described in the GASB statement is called a reverse repurchase agreement by governmental entities, savings and loan institutions, and others. When government securities dealers, broker-dealers, and banks acting in their capacity as dealers are seller-borrowers, they refer to agreements to transfer securities for cash and subsequently to repay cash for the securities as repurchase agreements.

Matched Book Transactions

Many dealers entering into RP-RRP agreements frequently use the term *matched book* transactions. In a matched book transaction or matched book operation, a dealer effects both a repurchase and reverse repurchase transaction with the same underlying securities for the same period of time, usually at slightly different rates. No market risk exists in a matched book transaction, but credit risk exists because the participants on either side may not fulfill their part of the agreement.

Time Periods Involved

RP-RRP agreements are negotiated for a variety of time periods, as follows:

- *Overnight RP-RRP agreements* mature in one day.
- *Term RP-RRP agreements* mature in more than one day.

- *Open RP-RRP agreements* have no specified maturity date; both parties typically have the right to close at any time. An effective open agreement may be achieved by continuously rolling over an overnight agreement into another overnight agreement.
- *RP-RRP agreements to maturity* mature on the same day as the underlying security.

Variations on the Basic Agreement

Many RP-RRP agreements entered into with government securities dealers permit the right to return similar, but not identical, securities when completing the transactions. This is commonly the case in RP-RRP transactions involving securities backed by pooled assets such as mortgages, for example, Government National Mortgage Association (GNMA) pass-through certificates and Federal Home Loan Mortgage Corporation (FHLMC) participation certificates. The terms of the agreements determine whether the securities are similar enough to make the transactions in substance borrowings and lendings of funds.

Some RP-RRP transactions involving the return of securities that are similar to, but not the same as, the securities originally transferred are referred to as dollar RP-RRP agreements. AICPA SOP 85-2 contrasts dollar RP-RRP agreements with basic RP-RRP agreements as follows:

Repurchase—reverse repurchase agreements involve identical securities, and the substance of the transactions is to borrow and lend funds. Dollar repurchase—dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. However, in agreements involving certificates collateralized by dissimilar pools [of mortgages], these transactions would be accounted for as sales and purchases.

Dollar RP-RRP agreements generally take the form of fixed coupon or yield maintenance agreements. In fixed coupon agreements, the parties agree that when the dollar RP-RRP agreement is completed, certificates will be returned having the same stated interest rate as those previously transferred. In yield maintenance agreements, the parties specify in the agreement the yield of the certificates to be delivered when the dollar RP-RRP agreement is completed. SOP 85-2 concludes that yield maintenance agreements constitute separate sale and purchase transactions. Therefore,

unlike fixed coupon agreements meeting specified criteria, yield maintenance agreements would be accounted for as completed sales and purchases.

Pricing and Yield on Repurchase and Reverse Repurchase Agreements

The repurchase price established in an agreement may be the same as the initial sale price. In that case, the rate of interest to be paid by the seller-borrower on repurchase is generally specified. Alternatively, the agreed repurchase price may be slightly higher than the initial sale price, reflecting the cost to the seller-borrower of using the buyer-lender's cash during the term of the agreement. Competition among buyer-lenders and seller-borrowers and their relative bargaining strengths all affect the yield on a particular RP-RRP transaction.

Haircuts

The excess of the market value of the securities transferred by the seller-borrower over the amount of cash transferred by the buyer-lender in an RP-RRP agreement is called a *haircut*. A haircut is a margin of safety sought by the buyer-lender to guard against a decline in the value of the collateral as a result of rising interest rates during the term of the agreement. Whether an agreement provides for a haircut, as well as the amount of the haircut agreed on, depends on competition among buyer-lenders and seller-borrowers and their relative bargaining strengths.

Haircuts generally range from a fraction of 1 percent to 4 or 5 percent, but may be higher in certain instances. The principal considerations in setting the haircut for a particular repurchase transaction are—

- The term of the agreement.
- The type of customer and its creditworthiness.
- The type of securities underlying the agreement, the length of time to their maturity, and the creditworthiness of the issuer of those securities.
- The volatility of the market value of the underlying securities.
- The differential between the interest rate specified in the agreement and the interest rate on the securities.

Book Entry Systems

All U.S. Treasury issues, except registered securities, and many U.S. government agencies' issues exist only in book entry form, in computerized files maintained by the twelve Federal Reserve Banks ("the Fed"), rather than in definitive (engraved paper) form. The Fed's book entry system is a securities safekeeping arrangement between the Fed and its securities safekeeping account customers. Any depository institution, as defined in the Monetary Control Act of 1980, may open securities safekeeping accounts with the Fed. Such depository institutions include commercial banks, savings and loan associations, credit unions, and certain other depositories. In addition, the Fed may also maintain securities safekeeping accounts for certain other entities, such as bankruptcy courts. A single depository institution may maintain several accounts in the system, for example, an account for securities owned, an account for securities held in trust for others, and an account for clearing dealers' transactions. Under the system, book entry securities are transferred electronically between accounts based on input from the depository institution transferring securities from its account.

The Fed's book entry records are adjusted only for transfers between securities safekeeping accounts maintained at the Fed. Such transfers may involve accounts maintained by a variety of customers or a variety of accounts maintained by a single customer. Transfers of securities by a depository institution between accounts of two of its customers would be reflected only on its records (notation entry), but not on the Fed's records—unless the transactions involved a transfer between different safekeeping accounts maintained at the Fed by the particular depository institution, such as between a trust safekeeping account and a clearing safekeeping account. Similarly, a transfer of book entry securities between two customers (for example, a dealer and the dealer's retail customer) of a depository that does not maintain a safekeeping account with the Fed would result in a notation entry on the depository's records but not on the records of either an intermediary depository or the Fed. A dealer's book entry transaction not involving a change in book entry securities accounts, such as a transfer between two customers or a sale with an agreement to repurchase at a later date in which the dealer retains the securities, also results in an entry in the dealer's records but no adjustment to an intermediary depository's records or those of the Fed.

Regulatory Environment

Dealers that engage exclusively in U.S. government securities, including some of the thirty-six primary dealers, are currently not directly regulated by any governmental or self-regulatory agency in their capacity as dealers in government securities. Government securities are exempt from registration under the Securities Act of 1933 and the Securities Exchange Act of 1934, and dealers that engage exclusively in government securities transactions are exempt from regulatory oversight by the SEC. Transactions in government securities, however, are subject to the antifraud provisions of the federal securities laws (for example, sections 17(a) of the 1933 Act and 10(b) of the 1934 Act).

Primary Dealers

The FRB monitors the activities and financial stability of the thirty-six primary dealers, which report their trading positions and market activity daily to the Fed. The primary dealers also provide the Fed with monthly financial statements and annual reports and are subject to some degree of surveillance and oversight. Some primary dealers are components of banks that are subject to the regulatory oversight of other federal bank regulators, such as the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC), and any holding companies of those banks are also required to report financial and other information to the SEC. Some primary dealers are components of diversified securities broker-dealers that are subject to regulation by the SEC.

Secondary Dealers

In contrast to the primary dealers, dealers engaging exclusively in government securities in the secondary market are not subject to the surveillance or reporting requirements of any regulatory authority. However, the FRB receives a limited number of reports submitted voluntarily by some unregulated dealers. On May 20, 1985, the Federal Reserve Bank of New York issued *Capital Adequacy Guideline for U.S. Government Securities Dealers* specifying capital adequacy and related reporting guidelines for unregulated dealers with which they are encouraged to comply voluntarily.

Although the secondary dealers are not required to report to the SEC, the SEC does have some investigative authority over dealers in

government securities that are suspected of having violated the anti-fraud provisions of the federal securities laws in connection with government securities transactions, and it can bring injunctive actions in federal court against such dealers for violations of the antifraud statutes. As a result of recent failures among secondary government securities dealers and the consequential losses to investors, Congress and others are considering the necessity of some form of regulation or monitoring of unregulated government securities dealers.

Other Participants

Many other participants in RP-RRP agreements are also monitored or regulated by various governmental and self-regulatory agencies: Most banks are subject to one or more of the following federal bank regulators—the FRB, the Comptroller of the Currency, and the FDIC; certain savings and loan associations report to the Federal Home Loan Bank Board (FHLBB); most credit unions report to the National Credit Union Administration; and nongovernmental pension funds are regulated by the U.S. Department of Labor under ERISA. Insurance companies, state-chartered banks, savings and loan associations, and credit unions are also regulated by various state agencies. State and local governments are subject to state laws and regulations or their own established oversight procedures.

Legal Considerations

A buyer-lender in an RP-RRP transaction does not automatically obtain a perfected security interest in the underlying securities. Economically, an RP-RRP agreement involves a loan of money collateralized by securities or, conversely, a borrowing of securities in exchange for money. To create a valid security interest under the Uniform Commercial Code, the safest approach is to have a separate signed agreement specifically creating the security interest and to perfect the security interest, normally by possession of the collateral.⁴

4. The Uniform Commercial Code has been enacted, with some variations in all states except Louisiana. Article 8 of the model code, which deals with investment securities, was revised in 1977 to cover, among other things, book entry securities, but only some states adopted the revisions. In those that did, a security interest may be created and perfected in several ways, none of which requires the filing of a formal notice. Even if a security interest has not been created and perfected, the courts may choose, for one reason or another, to recognize a particular RP-RRP agreement as a secured loan. Currently ongoing litigation concerning Bevill, Bresler & Schulman Asset Management Corp., E.S.M. Government Securities, Inc., and other dealers may yield

Some RP-RRP participants provide explicitly in their agreements for security interests that would have standing as such under the Uniform Commercial Code. More commonly, however, RP-RRP transactions do not create security interests; instead, they involve only a pair of matched confirmations that are similar to an initial purchase or sale transaction coupled with a forward contract that will reverse the first transaction at a price that provides for the payment to the buyer-lender of what is, in effect, interest.

The treatment of the securities underlying an RP-RRP agreement is critical if the interests of the seller-borrower and buyer-lender are to be protected. If the seller-borrower overcollateralizes the agreement by selling the securities at too great a discount from the market price, its rights to the overage may be diminished or lost entirely in the event of the buyer-lender's bankruptcy. In that case, the seller-borrower may find that neither the securities nor funds to replace the securities are available for the buyer-lender to complete the RP-RRP transaction and, as a result, may incur an economic loss to the extent the agreement was overcollateralized. (The accounting loss would be greater than the economic loss if the market value of the securities is below their book value; the accounting loss would be less than the economic loss if the market value is above the book value.) Conversely, the buyer-lender's rights to the collateral in an RP-RRP transaction may be seriously affected if the buyer-lender fails to take possession of the securities, either itself or on its behalf by a third party serving as its agent. In current bankruptcy cases involving secondary dealers, several RP-RRP buyer-lenders that did not take possession of their securities may be unable to recover them.

Possession of the underlying securities may be obtained either directly by the buyer-lender or indirectly through a third party that, acting as the buyer-lender's agent, takes possession of and holds the securities for the exclusive use of the buyer-lender. Such a custody agreement should be evidenced in writing for the buyer-lender's protection, and the custodian should be required to specifically identify and segregate the securities held for the buyer-lender.

The 1984 amendments to the U.S. Bankruptcy Code exempt certain RP-RRP agreements of a fixed term of one year or less from the automatic stay orders typically issued by bankruptcy courts. That is,

judicial precedents on what is required to perfect a security interest under the Uniform Commercial Code. Moreover, questions have been raised as to whether implications could be drawn from relevant U.S. Treasury regulations that would cast doubt on the applicability of the 1977 revisions to the Uniform Commercial Code as they apply to U.S. government securities. As suggested in a later section of this report, auditors should consider whether an opinion from the client's legal counsel should be obtained regarding the status of the securities underlying an RP-RRP transaction.

in the event of the seller-borrower's bankruptcy, the buyer-lender can liquidate the underlying securities and in effect set off the collateral against the loan. For the transaction to qualify as an RP-RRP agreement as defined in the code, the underlying securities must be transferred to the buyer-lender and must comprise "certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States."⁵

Government securities dealers, but not certain financial institutions such as commercial banks and savings and loan associations, are subject to the Bankruptcy Code. The FHLBB in October 1984 indicated that its policy, in cases in which the Federal Savings and Loan Insurance Corporation (FSLIC) was the receiver of an insured institution, was not to limit the contractual rights of the buyer-lender to sell securities underlying repurchase agreements except in cases of fraud or other extraordinary circumstances. Similar action has not been taken, however, by the FDIC, but its practices have been consistent with those formally adopted by the FHLBB. The powers of receivers and conservators of bankrupt institutions that are not subject to the Bankruptcy Code are governed by many differing federal and state statutes and regulations. Accordingly, the rights of each party to the underlying securities in case of insolvency may not always be treated by the courts in the manner specified in the particular RP-RRP agreement (or master agreement). Nevertheless, those agreements should contain language that defines what each party intends its rights to be.

Accounting and Reporting Considerations

The existing guidance on accounting for RP-RRP agreements generally views such agreements as financing transactions. The securities said to be purchased or sold as part of an RP-RRP transaction are not recognized as such for accounting purposes by either the seller-borrower or the buyer-lender; instead, the transaction is generally accounted for by both parties as a collateralized loan, with the related asset and liability reflected in financial statements at the contract value of the agreement.

Existing guidance on accounting for RP-RRP agreements does not address all the possible varieties of those agreements or of transactions that appear to have many elements of RP-RRP agreements.

5. Pub. L. No. 98-353, Subtitle F, section 391.

For example, RP-RRP agreements to maturity and overnight RP-RRP agreements that are continuously “rolled-over” are not specifically addressed in the literature, and AICPA SOP 85-2 does not address transactions in mortgage-backed securities that the seller-borrower has held for less than thirty-five days. Accordingly, in order to be able to evaluate the substance as well as the legal form of RP-RRP and similar transactions, the auditor should understand the intent of the parties that engage in such transactions. The substance of the transaction is the primary determinant of whether it should be treated as a borrowing or as a purchase and sale of securities.

AICPA Audit and Accounting Guides

The AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, recognizes RP-RRP transactions as financing transactions and discusses them from the viewpoints of buyer-lenders and seller-borrowers. From the viewpoint of buyer-lenders, the guide states—

For financial reporting purposes, the transaction involving the same or substantially identical securities is treated as a receivable collateralized by the security purchased, not as part of the buyer’s trading or investment account.

The guide captions the collateralized receivable as “securities purchased under agreements to resell.”

From the viewpoint of seller-borrowers, the guide states—

Securities owned that are sold by the broker or dealer subject to a repurchase agreement are treated as collateral for financing transactions and not as sales of trading or investment positions. Therefore, they should be reported with trading and investment accounts, at market value,⁶ with the amount of the repurchase agreement reflected as a liability.

The guide captions the liability as “securities sold under agreements to repurchase.”

The AICPA Industry Audit Guide, *Audits of Banks*, recognizes RP-RRP agreements as financing transactions, with the borrowing reflected as a liability and the securities sold reflected as investments.

The AICPA Audit and Accounting Guide, *Savings and Loan Associations*, states that material RP-RRP agreements should be disclosed in the financial statements. The guide specifies that when a savings and loan association enters into an RP-RRP agreement as a

6. Broker-dealers maintain trading and investment accounts at market value.

seller-borrower, a liability should be established for the amount of the proceeds. The investment account should not be relieved of the securities that underlie the agreement.

AICPA SOP 85-2

The AICPA guides provide accounting guidance for basic RP-RRP agreements (sometimes referred to as “plain vanilla” agreements). SOP 85-2 provides accounting guidance for dollar RP-RRP agreements. The statement concludes that fixed coupon dollar RP-RRP agreements meeting certain criteria should be considered financing transactions and reported accordingly; yield maintenance RP-RRP agreements should be accounted for and reported as completed purchases and sales of securities.

GASB Proposed Statement

The GASB’s proposed statement parallels the guidance in the AICPA guides and SOP 85-2. The statement provides the following accounting and reporting guidance for repurchase and reverse repurchase and fixed coupon repurchase and reverse repurchase agreements.

Balance Sheet

The assets and liabilities arising from reverse repurchase and fixed coupon reverse repurchase agreements should not be netted on the balance sheet. Reverse repurchase and fixed coupon reverse repurchase agreements should be reported as a fund liability, regardless of the maturity date of the agreement, or a proprietary fund liability as “Obligations under reverse repurchase agreements,” and the underlying securities should be reported as “Investments.”

Operating Statement

In the operating statement, the interest earned on repurchase and fixed coupon repurchase agreements should be shown as interest income. The interest cost of the reverse repurchase and fixed coupon reverse repurchase agreements should be reported as interest expenditure/expense. The interest cost associated with reverse repurchase or fixed coupon reverse repurchase agreements should not be netted against interest earned on any associated investments.

The statement also provides the following accounting guidance for yield maintenance repurchase and reverse repurchase agreements.

Yield maintenance repurchase and reverse repurchase agreements should be accounted for as a purchase and sale and sale and pur-

chase of securities, respectively. Securities purchased should be recorded at cost and a gain or loss on investments should be recognized on securities sold.

The proposed statement requires disclosure of additional information regarding the governmental entity's investment policies, the agreement activity during the year, and agreements outstanding at year-end.

FASB Statement No. 65

The accounting for RP-RRP agreements that is specified by Financial Accounting Standards Board (FASB) Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, is similar to the accounting in the AICPA audit and accounting guides and the proposed GASB statement. The FASB statement also describes the following circumstances in which informal agreements should be treated as formal RP-RRP agreements:

Mortgage loans or mortgage-backed securities also may be transferred temporarily without a repurchase agreement but under circumstances that indicate a repurchase agreement exists on an informal basis, for example, when the mortgage banking enterprise (a) makes all of the necessary marketing efforts, (b) retains any positive or negative interest spread on the loans or securities, (c) retains the risk of fluctuations in loan or security market values, (d) reacquires any uncollectible loans, or (e) routinely reacquires all or almost all of the loans or securities from the bank or other financial institution and sells them to permanent investors. Mortgage loans and mortgage-backed securities held for sale that are transferred under formal or informal repurchase agreements of the nature described in this paragraph shall (1) be accounted for as collateralized financing arrangements and (2) continue to be reported by the transferor as being held for sale.

Risks Involved in Repurchase and Reverse Repurchase Agreements

Each party that enters into an RP-RRP agreement faces several types of risk. These are business risk, market risk, credit risk, and the risk of collateral loss, each of which is discussed below. Also discussed are controls that parties to RP-RRP transactions can install to reduce those risks.

Business Risk

The business risk associated with RP-RRP agreements is that a party entering into them will misunderstand their terms and therefore

misunderstand the economics of the transactions and incorrectly assess the risks it is in fact assuming, the return it hopes to earn, or the financing costs it is incurring. This in turn can result in incorrectly pricing the agreements or in incorrectly treating accrued interest in pricing the underlying securities. Particularly because RP-RRP agreements are not always labeled as such, and vice versa, parties to them may not always be aware of the risks and returns being contracted for and accordingly may not account for them properly.

Market Risk

All securities are subject to market risk in that their prices can change. The prices of government securities vary inversely with changes in interest rates; while price changes may be small, they can result in significant gains or losses because of the large dollar amounts involved in many government securities transactions. Price changes may affect the ability of one party to an RP-RRP agreement to continue to finance it and the ability of the other party to replace the securities when the transaction is supposed to be reversed. Changes in prices also affect the margin in a transaction (the haircut) and may create a need for the seller-borrower to transfer additional securities or return cash. Accordingly, both parties should monitor the market value of securities subject to RP-RRP agreements, including accrued interest, on a daily basis.

Credit Risk

Credit risk is the risk that a borrower may not repay a loan. An RP-RRP agreement can be viewed as a loan of cash by one party and a loan of securities by another. When the agreement is completed, both loans are repaid. There is a risk that a buyer-lender who has sold or otherwise transferred the securities to third parties will not have sufficient resources at the maturity of the agreement to regain possession of the securities required for resale to the seller-borrower. There is also a risk that the seller-borrower will not have sufficient funds to repay the loan (repurchase the securities). Thus, credit risk is faced by both parties to the transaction. Particularly because government securities dealers are often organized as separate affiliates of securities broker-dealers, parties to RP-RRP transactions should be careful to identify the specific entity with which they are doing business.

The risk that the issuer of the underlying securities may default is also present, except in the case of securities issued or guaranteed by

the U.S. government or its agencies. This risk pertains to RP-RRP agreements involving bankers' acceptances, negotiable certificates of deposit, mortgage-backed obligations of nongovernmental enterprises, and similar instruments. If the issuer of the underlying securities defaults, both participants to the RP-RRP agreement are still obligated to perform and complete the transaction.

The credit risk to which a particular entity may be exposed can be affected by the extent to which the entity's RP-RRP position is concentrated in any one underlying security or with any one party. Credit risk is related to market risk in that changes in market prices in general and resulting economic losses may affect a seller-borrower's ability to repay the loan (repurchase the securities) or a buyer-lender's ability to return the securities. The extent of credit risk, therefore, may not be evident if the parties to the transaction do not continually review and evaluate their securities positions based on market values, including accrued interest.

The extent of credit risk faced by a party that enters into RP-RRP transactions with a government securities dealer is also related to the dealer's business policies and practices regarding control and use of collateral, the extent of the haircut on securities serving as collateral, the extent to which the dealer maintains a matched book, and the dealer's capitalization. In addition, uncertainties surround the legal status of the securities that the parties to RP-RRP transactions view as collateral, as noted in the section on "Legal Considerations."

Risk of Collateral Loss

When a seller-borrower transfers securities to a securities dealer under an RP-RRP agreement, there is a risk that the dealer may not be able to reverse the transaction by selling the securities back at the agreed-upon price. If the seller-borrower has the legal right to set off the securities against the borrowed funds, the potential economic loss is limited to the excess of the market value of the securities plus accrued interest at the date of the sale over the amount borrowed, plus or minus any change in that market value and accrued interest.⁷ In that case, the risk of losing the collateral is essentially the same as market and credit risk. If the seller-borrower does not have the legal right of setoff, the potential economic loss extends to the full value of the securities, including accrued interest.

7. The accounting loss may be greater or less than the economic loss if the book value of the securities is above or below their market value.

If a buyer-lender under an RP-RRP agreement with a securities dealer does not perfect a security interest in securities purchased, for example, by having a signed agreement and by taking possession, either directly or through a custodian acting as its agent, the potential economic loss also extends to the full value of the securities and the risk assumed becomes that of an unsecured lender, namely, credit risk. Collateral risk for the buyer-lender is reduced if definitive collateral is held by the dealer's custodian as the dealer's agent with specific identification of the assignee or if book entry collateral is transferred directly or by a notation entry. When definitive collateral is locked up by the dealer in safekeeping and segregated and identified by customer, collateral risk will be reduced only if the dealer's system of internal control over securities held in safekeeping is adequate. Collateral risk is reduced further if the buyer-lender or its agent, which could be the dealer's bank acting as the lender's agent, takes possession of the collateral.

Controlling Risk

The various risks faced by entities entering into RP-RRP transactions are generally reduced by instituting controls over the authorization, processing, and recording of those transactions. Such controls might include policies and procedures that (1) address the competency of personnel who are authorized to enter into RP-RRP transactions; (2) require transactions to be executed pursuant to written contracts setting forth the rights and obligations of the several parties; (3) place trading limits on personnel; (4) restrict agreements with specified dealers and to specified securities; (5) require reviews of transactions for reasonableness and completeness; (6) require periodic evaluations, preferably daily, of the appropriateness of the amounts of collateral or borrowings; and (7) require evaluations of credit, market, and collateral risk.

Auditing Considerations

The existing auditing literature addressing RP-RRP transactions is reviewed in this section and additional insight is provided for auditors in applying the guidance included in that literature.

Existing Auditing Literature

The standards of field work and Statements on Auditing Standards (SASs) that interpret those standards provide broad guidance on

assessing control risk⁸ through the study and evaluation of internal control and on controlling detection risk⁹ through obtaining and evaluating sufficient, competent evidential matter. The objective of that broad guidance, which applies to all engagements and therefore should be considered by auditors of clients that enter into RP-RRP agreements, is to assist auditors in designing, performing, and evaluating the results of procedures that will reduce audit risk¹⁰ to an appropriately low level. SASs are not intended to and do not provide detailed guidance on auditing specific industries, types of transactions, or classes of accounts.

Several of the AICPA audit and accounting guides address RP-RRP agreements in the context of audits of clients in specialized industries. Proposed guides, some of which are revisions of existing guides, also address those agreements. A summary of the auditing guidance in the existing and proposed guides follows.

Audits of Brokers and Dealers in Securities. The accounting and reporting considerations section of this report explains that the broker-dealer guide treats RP-RRP agreements as financing transactions. The guide explains that when the broker-dealer is the buyer-lender, the transaction is accounted for and reported as a receivable collateralized by the securities purchased. When the broker-dealer is the seller-borrower, the borrowing is reflected as a liability. Therefore, auditors of broker-dealers engaging in RP-RRP transactions are essentially dealing with the examination of investments, collateralized receivables, and debt.

The guide primarily discusses the study and evaluation of internal controls and the examination of accounts that are peculiar to the stockbrokerage industry. Accordingly, considerable attention is given to the examination of stock record positions and investments,

8. Control risk is defined in Statement on Auditing Standards (SAS) No. 47, *Audit Risk and Materiality in Conducting an Audit*, as "the risk that error that would occur in an account balance or class of transactions and that could be material, when aggregated with error in other balances or classes, will not be prevented or detected on a timely basis by the system of internal accounting control." Business risk, market risk, credit risk, and collateral risk are aspects of inherent risk, which is defined in SAS No. 47 as "the susceptibility of an account balance or class of transactions to error that could be material, when aggregated with error in other balances or classes, assuming that there were no related internal accounting controls."

9. Detection risk is defined in SAS No. 47 as "the risk that an auditor's procedures will lead him to conclude that error in an account balance or class of transactions that could be material, when aggregated with error in other balances or classes, does not exist when in fact such error does exist."

10. Audit risk is defined in SAS No. 47 as "the risk that an auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated."

and a chapter is devoted to a discussion of U.S. government and money market instruments—the major securities underlying RP-RRP agreements. The study and evaluation of internal controls and the examination of collateralized receivables and debt transactions and balances involve many procedures that are not specific to any industry and therefore are not repeated in the broker-dealer guide. The guide provides illustrative financial statements that include RP-RRP agreements and their attendant disclosures. Like all other audit and accounting guides, the guide discusses accounting transactions, accounting records, internal accounting controls, and client procedures for safeguarding assets that are unique to its industry. The guides do not, however, attempt to provide detailed audit programs and questionnaires; the design of such audit tools is left to the auditor's judgment.

Audits of Banks. Chapter 9 of the guide, *Audits of Banks*, entitled “Federal Funds and Repurchase/Reverse Repurchase Agreements”, describes the nature of the transactions, their use by banks, and, as mentioned earlier in this report, the treatment of the agreements as financing transactions. The guide explains that the audit objectives for RP-RRP agreements are to obtain reasonable assurance that the asset or liability balances represent valid amounts due from or to others and that those balances and the revenues and expenses reported are stated in conformity with generally accepted accounting principles. Certain internal accounting control considerations and illustrative audit procedures are provided to assist the auditor in the examination. Illustrative financial statements that reflect RP-RRP agreements are also provided.

Savings and Loan Associations. In the savings and loan associations guide, the chapter on accounting principles and auditing procedures explains that an association may invest in short-term RP-RRP agreements and also may borrow under those agreements, using securities as collateral. The chapter provides auditing, accounting, and reporting guidance on investments in securities in general and also contains extensive discussion of loan examination procedures. The examination of borrowings under RP-RRP agreements is not specifically addressed, because audit procedures are similar to those followed in audits of other commercial and industrial enterprises.

Audits of State and Local Governmental Units and Audits of Investment Companies. The state and local governmental units guide

and the investment companies guide are currently being revised. Both revisions have been exposed for public comment and comments received are being considered. Both exposure drafts include discussions of RP-RRP agreements and of audit procedures related to the examination of securities and investments. Where applicable, auditing procedures for specific industry loans and liabilities are discussed.

Audits of Credit Unions. The new proposed guide, in common with the guides mentioned above, discusses RP-RRP agreements and explains that they are treated as short-term investment and borrowing transactions. The audit objectives and procedures for testing investment and liability accounts are also explained. The proposed guide has been exposed for comment.

The above review of existing and proposed audit and accounting guides suggests that much guidance is already available on auditing RP-RRP transactions, but that it is not codified in one document and not sharply focused on all of the risk factors associated with those transactions. The task force believes that more specific and illustrative guidance on auditing RP-RRP transactions is needed, because of the complexity of those transactions, the risks involved, and the controls over those risks. The guidance that follows reflects the task force's views on the nature of that guidance.

Auditing Considerations When Repurchase and Reverse Repurchase Agreements Exist

The auditor needs to determine whether audit risk has been reduced to an appropriately low level through the design, performance, and evaluation of the results of audit procedures when the entity being audited has entered into contracts that should be accounted for as RP-RRP agreements. Not all the considerations discussed below may apply to the audit of a particular entity. Accordingly, the guidance provided for addressing each of the considerations also may not apply to a particular audit situation. Rather, the procedures discussed should be viewed as ways to apply generally accepted auditing standards and the guidance contained in the various audit and accounting guides.

Auditing Accounts Reflecting Selling-Borrowing Transactions

Following is a discussion of factors to be considered by auditors of entities, other than securities dealers and banks acting in their

capacity as dealers, that enter into agreements to sell and later repurchase the same or substantially the same securities (reverse repurchase agreements).

Responding to Business Risk. Reverse repurchase agreements, like any other contract, can be structured to provide various combinations of risk and return. Conceptually, the terms and yield on a given investment should reflect the risk preferences and business objectives of each party to the agreement. A combination of risk and return that does not conform to the seller-borrower's intended preferences produces either too little return for the risk intended to be assumed or too much risk for the return actually earned; either situation is undesirable.¹¹ Seller-borrowers should be aware of the relationship of risk to return; the auditor should understand the nature of the transactions that are being used to achieve the intended business strategy.

The terms of individual reverse repurchase agreements, particularly those called overnight repos, are not always stated in writing, which may make it difficult to evaluate the risks assumed by the seller-borrower, particularly for overnight repos extended by the parties for long periods of time. Inadequate documentation also makes it difficult to determine that all reverse repurchase agreements are recognized as such, even if the dealer confirms transactions as sales and subsequent purchases, but it does not relieve the auditor of the responsibility to look for unrecorded agreements. A review of transaction activity may indicate that an event accounted for as two separate transactions—a sale and a subsequent purchase—is in reality a reverse repurchase agreement. The auditor should also be alert for invalidly recorded transactions, since accounting for what in reality are separate sale and purchase transactions as reverse repurchase agreements may reflect an attempt to avoid recognizing a gain or loss on the sale.

Responding to the Risk of Collateral Loss. In a reverse repurchase transaction, the seller-borrower must rely on the buyer-lender's integrity and its ability to be in a position to fulfill its obligation to honor the sale-back when the transaction is closed. Accordingly, the seller-borrower should have controls in place to monitor market risk and credit risk, and the auditor should be aware of the guidance provided below under those headings. Confirming the transaction with the dealer will provide evidence of the occurrence of the transaction, its terms, and

11. The risk addressed in this section is related to both the various risks inherent in the underlying securities and the risks associated with the other party to a transaction.

treatment of the securities, for example, that they were delivered to the buyer-lender; confirmation will not provide evidence about the existence, location, or transferability of the securities or about the dealer's ability to complete the transaction.

If the buyer-lender is a dealer, it will usually be impracticable to confirm the location of the securities delivered to the dealer as collateral. The dealer often will not be able to determine the location of the exact securities delivered because they are fungible with other securities of the same issue under the dealer's control and are commingled with those securities. In addition, the dealer may have appropriately used the securities for collateral in an RP-RRP agreement in which the dealer sold the securities to be repurchased at a later date. The seller-borrower and its auditor need not necessarily be concerned, however, about the location of securities transferred to the dealer as collateral, because their location does not necessarily affect the risk that the dealer may not complete the transaction.

The auditor should evaluate the adequacy of financial statement classification and disclosure of RP-RRP transactions in general and of the status of the collateral in particular. Those disclosures should enable financial statement users to assess the level of credit, collateral, and market risk to which the entity is exposed. The GASB is currently considering the disclosures that should be required of governmental units that enter into RP-RRP agreements. That guidance may also be helpful in considering the adequacy of disclosures by other entities that enter into such agreements. The AICPA Savings and Loan Associations Committee is also considering the disclosures that should be required of those institutions.

Responding to Market Risk. As noted earlier, changes in market interest rates may affect an entity's ability to continue to borrow via an RP-RRP transaction; the effect may be intensified if the entity's transactions are concentrated in one type of security. Changes in market prices may also result in over-collateralization or under-collateralization of the related borrowing. The auditor should understand the effects of changes in interest rates on the client's financial position and earnings and should review the current market values, including accrued interest, of securities serving as collateral to determine if the collateral is sufficient or excessive in relation to the contractual requirements of the loan.

Responding to Credit Risk. The auditor's principal concerns regarding the credit risk assumed by a client seller-borrower are (1) that the buyer-lender will not be able to complete the transaction by

returning (selling back) the securities at maturity of the agreement and (2) that the issuer of the securities pledged as collateral will default on interest or principal. The auditor's response to the latter risk is the same for securities underlying RP-RRP agreements as it is with any other securities and is therefore not addressed in this report. The risk that the buyer-lender will be unable to complete the transaction, however, is an additional risk in these types of transactions.

The auditor should consider the relevance and reliability of auditing procedures that may assist in assessing credit risk. The extent to which the client concentrates its reverse repurchase agreements with one dealer or a small group of dealers, whether those dealers are subject to reporting or regulatory requirements of one or more federal agencies, and the presence of audited financial statements all provide evidence helpful in evaluating credit risk.

If there is reason to question the creditworthiness of the buyer-lender, the auditor of the seller-borrower should consider consulting with legal counsel regarding whether, in the event of the buyer-lender's inability to return (sell back) the collateral securities, the seller-borrower has the legal right to set off the loan liability against the collateral. If the seller-borrower is unable to reclaim the collateral in the event of the buyer-lender's bankruptcy and if the legal right of setoff exists, the seller-borrower's economic loss is limited to the amount by which the value of the collateral plus accrued interest exceeds the principal of the loan,¹² and, accordingly, the credit risk associated with the default of the other party is lower than it would otherwise be. If the legal right of setoff is not present, however, the seller-borrower's loss is potentially the full value of the securities. In either situation, the auditor should consider reviewing and testing the client's controls over evaluating the buyer-lender's reputation and financial strength, or performing substantive tests that address the same audit objectives.

Analyzing credit risk requires an understanding of how government securities dealers run their businesses and of the steps that can be and are taken to reduce their exposure to market risk. Dealers are typically highly leveraged, with securities positions that are large multiples of their net capital, which can quickly be eroded by adverse market changes. By running a matched book, however, a dealer can reduce its exposure to market changes; accordingly, a seller-borrower that enters into RP-RRP agreements may face less credit risk by doing business with a dealer that has a matched book and

12. The accounting loss will differ from the economic loss if the book value of the collateral differs from its market value.

employs adequate procedures to control its credit risk than would otherwise be the case. (Of course, even if the dealer runs a matched book, the seller-borrower still faces credit risk resulting from the dealer's credit risk, namely that a customer of the dealer might not be able to complete its agreement with the dealer.) The seller-borrower's auditor may find it difficult, however, to obtain adequate competent evidence about the dealer's operations to reach a reliable conclusion on this matter.

If the buyer-lender is regulated or is an unregulated dealer that voluntarily complies with the Federal Reserve Bank of New York's capital adequacy guidelines, the auditor of the seller-borrower should review the latest audited financial statements and other available reports, such as the report on internal accounting control. The auditor may also want to determine the extent to which a registered dealer may have net capital in excess of statutory requirements and to consider the extent to which the excess enables the dealer to withstand adverse market changes. Other dealers may also have audited financial statements, and if this is the case, the auditor should also consider reviewing them. The auditor should also determine precisely the entity, within an affiliated group, with which the client is doing business. The auditor should be particularly alert to the existence and possible effect of transactions between the dealer and parties related to it.

Responding to Control Risk. The seller-borrower may attempt to mitigate any or all of the risks it faces by instituting controls over RP-RRP transactions. Those controls include, but are not necessarily limited to, (1) the use of master agreements entered into by authorized personnel that specify the terms of the transactions and the intent of the parties; (2) policies and procedures to restrict trading activity with individual dealers and in specific types of securities; (3) policies and procedures governing the use of hedging techniques to reduce market risk; (4) monitoring communications with dealers and reviewing dealer confirmations for unrecorded or inappropriately recorded transactions and for the reasonableness of interest rates; (5) monitoring the market value of collateral as a basis for adjustments to amounts borrowed or securities collateralizing the borrowings; (6) monitoring the reputation, financial stability, and creditworthiness of the buyer-lender as a basis for evaluating its ability to fulfill its obligation to return the collateral; and (7) monitoring the location and control procedures for the underlying securities. The auditor may deem it appropriate to review, test, evaluate, and rely on some or all of those controls.

Auditing Accounts Reflecting Buying-Lending Transactions

Following is a discussion of factors to be considered by auditors of entities, other than securities dealers and banks acting in their capacity as dealers, that enter into agreements to buy and later resell the same or substantially the same securities (repurchase agreements).

Responding to Business Risk, Market Risk, Credit Risk, and Control Risk. Most of the risks faced by seller-borrowers that enter into reverse repurchase agreements are also faced by buyer-lenders that enter into repurchase agreements, though their relative importance differs. Accordingly, the response to those risks by an auditor of a buyer-lender should be similar to the response by an auditor of a seller-borrower, but with different degrees of emphasis. The categories of risk are similar because in both the entity either owns securities or is committed to buy the same or substantially the same securities, and risks resulting from ownership of an asset are also present when an entity is obligated to buy the asset. Accordingly, the earlier discussion of the auditor's response to a seller-borrower's business, market, credit, and control risks is relevant to an auditor of a buyer-lender that enters into repurchase agreements.

Responding to Risk of Collateral Loss. The collateral risk faced by buyer-lenders may differ from that faced by seller-borrowers. A buyer-lender that is not a government securities dealer might not take delivery of the securities that serve as collateral. If it does, either directly or indirectly through its bank or other institution acting as its agent, collateral risk is less than may otherwise be the case; the auditor should confirm the occurrence and terms of the transaction and the seller-borrower's obligation to repurchase the securities and should count or confirm them, as appropriate. If the client hasn't already done so, the auditor should also consider requesting that the client obtain the opinion of legal counsel regarding the status of the collateral and the propriety or legality of the transaction.

Whenever a buyer-lender or its agent does not take delivery of the securities, the buyer-lender's auditor should confirm not only the occurrence and terms of the transaction and the obligation to repurchase the securities but also that they have not been delivered and are being held on the buyer-lender's behalf. The auditor should also recognize that when delivery is not made, the transaction has some of the attributes of an unsecured loan. Accordingly, the auditor should assess the reputation and financial strength of the seller-borrower and of its custodian, if applicable, and the materiality of the transac-

tion to the financial statements of both parties to it. Based on those assessments, the auditor should consider the desirability of obtaining a report from the custodian's auditor on its internal accounting controls over securities held in safekeeping, for which SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, provides guidance. That report should cover both the design of the system and compliance tests directed to specific objectives of internal accounting control over the custodial function. SAS No. 44 notes that circumstances may exist in which the auditor may need to discuss the custodian's auditor's procedures with that auditor, request that specific tests (such as balancing the security position and counting the collateral and ascertaining its ownership and location) be performed, or make such tests himself or herself.

Conclusions and Recommendations

The Special Task Force on Audits of Repurchase Securities Transactions was appointed to study the adequacy of the existing guidance provided by the American Institute of Certified Public Accountants for auditing repurchase and reverse repurchase (RP-RRP) transactions. The conclusions and recommendations that follow have been distilled from the preceding section of this report, and are directed to accounting and auditing standard-setters. Auditors of entities that engage in RP-RRP transactions need to understand the nature and use of those agreements, the regulatory environment faced by parties to them, the legal uncertainties surrounding their use, how they are accounted for, and the various risks associated with them. Accordingly, auditors should consider carefully the auditing suggestions in the body of this report and the background material that precedes those suggestions.

1. The task force reviewed existing Statements on Auditing Standards to ascertain whether they provide adequate guidance to auditors of entities that engage in RP-RRP transactions. The task force notes that auditing standards are measures of the quality of performance; they are not auditing procedures—steps to be performed for the specific transactions and other events and circumstances of specific entities. The task force believes that existing Statements on Auditing Standards provide adequate general standards and standards of field work and reporting for auditing RP-RRP transactions.
2. Audit and accounting guides illustrate the application of authoritative standards to specialized industries and specialized audit areas, for example, pension plans. After reviewing the guides or

exposure drafts pertaining to banks, savings and loan associations, securities broker-dealers, state and local governmental units, insurance companies, investment companies, credit unions, and pension plans, the task force concluded that additional educational materials on auditing RP-RRP transactions should be added to those guides. The supplemental guidance should include, but not be limited to, the auditing considerations and risks discussed earlier in this report and should be tailored to apply to the circumstances of the particular industry. If the recommendation that follows is adopted, it should also reflect the guidance that will be developed by the task force on auditing financial instruments.

3. Whether viewed from an accounting, legal, economic, or purely mechanical perspective, RP-RRP transactions are extremely complex. Moreover, it is likely that new financial instruments will evolve in the future that will make existing RP-RRP agreements appear simple in comparison. Consequently, the task force believes that a need exists for a comprehensive study of all existing financial instruments to provide guidance to auditors of parties to those instruments. That study should be part of an ongoing effort to monitor new financial instruments as they evolve, to alert the users of those instruments to the inherent attributes of those transactions and to the possible risks they may entail, and to provide guidance on a timely basis to auditors on how to respond to those risks. While it will be necessary to address those financial instruments, their risks, and their audit implications in separate audit and accounting guides for each affected party, we believe it may be efficient and educational if that effort were undertaken and guidance provided by a single task force that would consider those instruments from all appropriate perspectives.

4. As this report indicates, the level of risk assumed by the various parties to RP-RRP transactions varies widely depending on the terms of the agreement, the parties involved, and the legal status of the agreement. There is a presumption that the financial statements reflect both the risks of and the returns from those undertakings; the auditor's role includes judging whether they do. There is no more reason here, however, than in other areas for the auditor to assume the primary responsibility for preparing the financial statements of the transacting parties or the notes to the statements. The auditor is not, and should not be asked to be, a reporter of financial information; to do so would impair the auditor's independence.

Conceptually, the nature of, and the risks involved in, an RP-RRP agreement may affect the classification and valuation of accounts reported on the face of the financial statements or the disclosures

reported in the notes thereto. As discussed previously, because of such matters as the right to return similar but not the same collateral and the variation in the length of the agreement (possibly to the maturity of the security), difficult judgments must be made by financial statement preparers regarding their substance. The auditor's proper role is to evaluate whether accounting measurements, classifications, and disclosures reflect the substance of RP-RRP transactions and are in other respects in conformity with generally accepted accounting principles. The level of risk in some, but not all, RP-RRP transactions may be sufficiently high, particularly if the collateral has not been transferred¹³ or if its value is not monitored, that the proper way to account for them is as unsecured financing transactions, with full disclosure of the risks involved and of the legalities of the transactions. FASB Statement No. 5, *Accounting for Contingencies*, provides broad guidance on the disclosure of loss contingencies. The task force believes that more specific guidance is needed for preparers and auditors of RP-RRP transactions. The appropriate accounting standard-setting bodies should consider requiring disclosure information to assist users in assessing the risks assumed in RP-RRP agreements and of the amounts by which both the carrying value and the market value of the underlying securities in those agreements exceed the cash proceeds.

5. Several commentators have suggested that additional guidance might be necessary on the auditor's use of a special-purpose report on aspects of the internal accounting control of an organization that provides safekeeping and custodial services. The task force believes, as discussed under "Auditing Considerations," that if securities are not transferred to the buyer-lender or its custodian, it may be appropriate for the auditor of the buyer-lender to obtain a report from the custodian's auditor on controls instituted by the custodian over definitive or book entry securities held for the buyer-lender or to ask that auditor to apply agreed-upon procedures. SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, contains guidance on obtaining and using those reports, and accordingly the task force has no further recommendations in this area.

6. Several commentators have also suggested that additional guidance might be necessary on the use of confirmations in auditing RP-RRP transactions.

13. The task force has observed that, in certain instances, technological, practical, and economic considerations may preclude the effective transfer of collateral in an RP-RRP transaction.

Auditing literature addresses the appropriate use of confirmation procedures in several places. The task force believes that auditors should be mindful of the limited audit objectives about which the confirmation process provides evidence. Seller-borrowers that are not securities dealers generally transfer the securities that underlie RP-RRP transactions to the buyer-lenders, which need not and usually do not keep them. The buyer-lenders trade the securities or use them for other purposes, which the rights of ownership permit. Accordingly, an auditor of a seller-borrower cannot confirm the existence or location of the underlying securities, but should confirm the transaction with the buyer-lender as evidence of its occurrence and terms and that the related collateral was delivered.

Ordinarily, an auditor of an entity engaging in RP-RRP transactions as a buyer-lender is able to confirm the existence of securities that serve as collateral and are held by third parties acting as agent for the buyer-lender. However, buyer-lenders frequently neither take possession of the securities nor require that they be transferred to their custodial agents and identified as belonging to the buyer-lenders. In those cases, the auditor can request a confirmation of the occurrence of the transaction and its terms, the seller-borrower's obligation to repurchase the securities, and that they are being held on the buyer-lender's behalf. Those confirmations by themselves do not diminish either collateral or credit risk; accordingly, the auditor should also assess the reputation and financial strength of the seller-borrower and of its custodian, if appropriate, and the materiality of the transaction to the financial statements of both parties involved. Based on those assessments, the auditor should consider the desirability of obtaining an SAS No. 44 special-purpose report, either on internal accounting control or on the results of the application of agreed-upon procedures. The task force does not believe that it is in the public interest to recommend, or request others to require, that buyer-lenders always transfer securities underlying RP-RRP transactions into their possession or control, primarily because that would likely narrow the market for such instruments as a result of the relatively high costs of transferring the securities (irrespective of whether the securities are in definitive or book entry form). However, the task force does recommend that appropriate accounting standard-setting bodies consider whether the status of collateral in these circumstances should be a required financial statement disclosure.

7. Several commentators on the recent failures of government securities dealers noted the presence of transactions between those dealers and parties related to them. Those commentators suggested that additional guidance might be necessary to assist auditors in

identifying and auditing RP-RRP transactions involving related parties. Related party transactions are not unique to RP-RRP agreements, and those agreements do not *per se* create related party transactions. The task force believes, however, that it would be helpful to provide guidance on related party transactions in addition to that presently found in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, and related interpretations.¹⁴ The task force recommends that an interpretation of SAS No. 45 be issued reminding practitioners that, because of the high risk inherent in related party transactions, they should examine sufficient competent evidence to be able to understand the business purpose and economic effects of sometimes complex related party transactions. (The task force has been advised that such an interpretation is currently under preparation.)

SAS No. 45 requires the auditor to obtain information about the financial capability of a related party when such information is necessary to fully understand a particular transaction, and notes that the auditor should determine the degree of assurance required and the extent to which available information provides such assurance. Ascertaining the financial capability of a related party or understanding the financial effect of a transaction not entered into at "arm's length" may occasionally require the auditor to examine the financial statements of the related party or apply other procedures sufficient to meet those objectives.

In addition, SAS No. 45 notes the auditor's responsibility to determine the existence of related parties and the specific procedures that may be employed in doing so. SAS No. 19, *Client Representations*, specifies that written representations the auditor should obtain from the client should include information about related party transactions and related amounts receivable or payable. If the client has not instituted procedures for identifying transactions with related parties, the auditor may also wish to obtain additional representations from senior management and the board of directors about the existence of those transactions.

14. The staff of the Auditing Standards Division is authorized to issue interpretations to provide timely guidance on the application of pronouncements of the Auditing Standards Board, whose members review the interpretations. An interpretation is not as authoritative as a pronouncement of the Auditing Standards Board, but auditors should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned.

Glossary

Terms Common to Savings and Loan Associations

abstract of title A history of title transactions or conditions affecting the title of a property. Such a document does not convey title or guarantee title. See also **title opinion**.

acquisition credits See **loan fee**.

amortized mortgage A loan that requires regular periodic (usually monthly) principal payments as opposed to a straight mortgage. See **straight mortgage**.

appraised value A valuation made by an approved or licensed appraiser involving facts, assumptions, and techniques considered by the appraiser to be appropriate in a given circumstance. An association appraiser may be a director or an employee. An independent appraiser, usually licensed, is not an employee of the association.

appropriated retained earnings See **reserves**.

brokered savings deposits Savings deposits that have been obtained for an association by brokers.

building loan See **construction loan**.

capital stock Commonly referred to as nonwithdrawable shares, permanent reserve shares, or guarantee (also guaranty) stock. Ownership of capital stock associations rests with the stockholders. In some states, owners of savings accounts and borrowers in the association have voting rights even though they are not stockholders. The board of directors is elected by the stockholders and members. It is customary for members to sign proxies delegating their voting rights to an officer, director, stockholder, or proxy committee.

capital stock associations Associations having stockholders, in contrast to mutual associations.

cease and desist order An order by the FHLBB to discontinue an unsafe or unsound practice.

certificate of title Opinion written by attorney regarding condition of the title to property. The attorney's opinion is based on his findings from examining public records. See also **title opinion**.

chattel paper Instrument evidencing pledge of property other than real property.

closing costs Amount paid by borrower at closing of loan. Generally includes loan fee, attorney's fee, cost of abstract of title or title insurance, recording fee, and appraisal fee.

commercial paper A negotiable instrument, usually a short-term unsecured promissory note issued by a corporation and sold to investors, primarily other companies.

condominium A system of direct ownership of a single unit in a multiunit structure. The individual owns the unit in much the same manner as if it were a single-family dwelling; he holds direct legal title to the unit and proportionate interest in the common areas and underlying ground. See also **cooperative**.

conversion The change of a savings and loan association from a mutual to a stock form of charter. The term can also apply to a change from a state to a federally chartered savings and loan association and vice versa.

cooperative A system of indirect ownership of a single unit in a multiunit structure. The individual owns shares in a nonprofit corporation, which holds title to the building; the corporation in turn gives the owner a long-term proprietary lease to the unit. See also **condominium**.

construction loan First mortgage loan to finance construction cost.

deed A written instrument conveying title to real estate. A warranty deed guarantees a perfect title, and the grantee is entitled to recover from the grantor any loss sustained by reason of imperfect title. A quit-claim deed conveys only the grantor's title, whatever its state. A deed-taken-in-lieu-of-foreclosure is usually a quit-claim deed. See also **quit-claim deed**.

deed-of-trust Conveyance of title to a trustee as security for a debt.

deficiency judgment Judgment against a debtor, which represents the excess of his debt over proceeds realized from the security to the debt.

deposit association A savings and loan association that designates savings accounts as “deposits” rather than “member accounts” or “share accounts.”

direct holding costs The costs or expenses directly associated with holding real estate owned, including (a) real estate taxes and similar assessments, (b) insurance, (c) maintenance and upkeep, and (d) average cost of all capital (debt and equity).

direct reduction mortgage Mortgage being amortized over a definite period of time having periodic (usually monthly) payments of a like amount with the payment applied first to interest and then to principal.

dividend Amount paid to savers (members) (called interest in some states, and not called interest in other states) and an expense of the association in arriving at net income; or, amount paid to stockholders of capital stock associations.

dividend-anticipation loan See **passbook loan**.

dividend-day loan See **passbook loan**.

dormant account A savings account in which there has been no activity, other than interest credited, for a specified number of years.

education loans Loans made to students or their parents to finance higher education.

escheat Process whereby unclaimed property, including savings accounts, wages, and dividends, passes to the state. The escheat laws of the states vary.

escrow Delivery of deed to a third person who will release the deed to the grantee upon fulfillment of certain specified conditions. Also commonly used to designate accounts to which are credited the periodic deposits by borrowers for the payment by the association of real estate taxes and insurance premiums when they become due.

estimated discount factor A discount percentage applied to an estimated future cash selling price (or its equivalent) of real estate owned to reduce it to present value in the determination of estimated net realizable value.

Farmers Home Administration A government agency that provides mortgage credit in areas (towns of not more than 10,000 population) where private credit agencies are unable to fulfill the needs.

Federal Credit Reporting Act Defines the rights of applicants for credit, particularly if credit is denied or the charge for credit is increased due to a credit agency report.

Federal Guide A loose-leaf service published by the United States League of Savings Associations covering laws and regulations pertinent to savings and loan associations.

federal funds A loan by a bank (or borrowings by a bank) to decrease (or increase) its reserve account with a Federal Reserve Bank. A member bank of the Federal Reserve System is required to maintain a legal reserve comprising (a) funds on deposit in the bank's reserve account with a Federal Reserve Bank and (b) currency and coin on hand. If a bank's legal reserve is deficient it may borrow federal funds to increase its reserve position. The loans are generally repayable the following day and are commonly referred to as "federal funds purchased" or "federal funds sold." Savings and loan associations may loan cash to a member bank of the Federal Reserve System. The loans may be secured by U.S. government or federal agency securities.

Federal Home Loan Bank (FHLB) One of the district (presently twelve) banks comprising the Federal Home Loan Bank system. Each bank is identified by including the name of the city in which it is located in the title. The primary function of the FHLB system is to provide credit for qualifying thrift institutions of the savings and loan type, savings banks, and insurance companies engaging in long-term mortgage financing.

Federal Home Loan Bank system The network of twelve district Federal Home Loan Banks.

Federal Home Loan Mortgage Corporation (The Mortgage Corporation) The corporation was chartered by an act of Congress in July, 1970, for the purpose of assisting in the development and maintenance of a secondary market in conventional residential mortgages. The corporation purchases mortgages from financial institutions, the accounts of which are insured by an agency of the U.S. government. The corporation sells mortgages principally through mortgage participation certificates (PC's) representing undivided interest in a group of conventional mortgages. PC's qualify as mortgages for certain regulatory and tax purposes.

Federal Housing Authority (FHA) The Federal National Housing Act, approved in 1934, established the FHA. The FHA does not make loans; rather, it insures certain types of loans made by

associations and other lenders. Principally, insofar as associations are concerned, the types of insured loans are (a) unsecured property improvement loans and (b) mortgage loans on one- to four-family homes. Insurance premiums are paid by the borrower to the association, which remits to the FHA. On FHA Title I improvement loans, a reserve account for each lender is maintained by the FHA. The regulations and the amount of the reserve account, as for FHA Title I loans, govern the amount of insurance by loan and by lender. The regulations are complex and subject to change and are not described in this guide. If an insured mortgage loan is defaulted, the association receives cash approximating 90 percent of the amount due the association and certificates of claim representing the remainder plus expenses sustained in foreclosure, rehabilitation expenses, and so forth, in exchange for title to the collateral property. In other cases, the association may receive from FHA an amount representing the insured portion of the estimated loss in excess of the value of the property, and retain title to the property which it must then dispose of. Recommended procedure is to record such certificates at \$1.00. Appraisals of property securing insured mortgage loans are required to be made by FHA-approved appraisers.

FHA Title I loan Home improvement loan insured by FHA.

federal insurance reserve A part of net worth that is distinguished from undivided profits by the fact that once earnings are transferred to this account, losses are the only charges permitted to the account. All insured associations are required to maintain an amount equal to a certain percentage of savings capital in this account.

Federal National Mortgage Association (FNMA) Often referred to as "Fanny Mae," its purpose is to provide a secondary market for residential housing mortgages. Federally-chartered associations (state laws vary) may sell mortgages to FNMA and thereby invest in FNMA's stock, and they may invest in FNMA's obligations.

federal savings and loan association A savings and loan association chartered by the FHLBB.

fidelity bond Insurance against losses arising from dishonest acts of employees and involving money, merchandise, or other property; persons or positions may be covered by fidelity bonds.

Financial Managers Society of Savings Institutions, Inc. An organization whose membership consists principally of accounting and auditing officers and financial personnel of associations. This

organization is affiliated with the United States League of Savings Associations.

first mortgage A mortgage that is a first lien against real estate.

fixed rate, fixed term accounts Certificates of deposit issued by associations at fixed interest rates for specified time periods.

foreclosure Legal process protecting the mortgagee in case of nonpayment and other defaults on the mortgage by the mortgagor, whereby the mortgagee obtains title to the collateral. See also **quit-claim deed**.

foreclosed real estate Real estate acquired by foreclosure or deed in place of foreclosure, in contrast to real estate purchased for sale or development and association premises.

GI loan See **Veterans Administration (VA) insured loan**.

Government National Mortgage Association (GNMA) A wholly owned corporate instrumentality of the United States government, which purchases, services, and sells mortgages insured or guaranteed by the Federal Housing Administration (FHA) and the Veterans Administration (VA) and may perform other secondary market functions to support the home mortgage market. The association is often referred to as "Ginny Mae."

grant Transfer of real estate.

grantee One to whom real estate is granted.

grantor One who grants real estate.

guarantee-stock associations See **capital stock associations**.

Home Owners Loan Act Created the federal savings and loan system and is the legal basis for regulation by the FHLBB.

impounds Advance payments by borrowers for taxes and insurance.

improved real estate Real estate other than "raw" (unimproved) land.

improvement loan A loan for improvement of real estate. Usually the loans are unsecured. See also **FHA Title I loan** and **uninsured improvement loan**.

initial service charge See **loan fee**.

Institute of Financial Education An educational organization, which offers correspondence courses and classroom instruction in association-oriented subjects. The institute has chapters in

many cities. This organization is allied with the United States League of Savings Associations.

interest Amount paid or received for use of money. See also **dividend**.

investment certificate A savings account in the form of a certificate issued by an association. Certificate accounts may differ from passbook accounts in several ways. Dividends (or interest) may be paid by check to a certificate holder or credited to his account. Certificates may have specific maturity dates; if a saver does not withdraw his funds before the maturity date, he receives a higher rate of earnings than paid on a passbook account. If a saver withdraws his funds before maturity, his earnings may be penalized. Certificates do not carry stockholder liability.

junior mortgage A mortgage, for example, second mortgage, subordinate to prior or other mortgages.

legal reserve Reserve required to be maintained by federally or state-chartered associations. See also **reserves**.

level-payment mortgage See **direct reduction mortgage**.

lien A claim on property.

liquidity See Sections 523.0 through 523.14 of *Rules and Regulations for the Federal Home Loan Bank System*. The liquidity requirements are imposed on all members of the FHLBB system.

lending area The geographical area within which an association is required to limit its ordinary lending activities.

limited facility A branch office facility providing less than a full line of services.

loan fee Amount charged by mortgagee for granting a loan. Various referred to as "points," "acquisition credits," or "initial service charge." Loan fees are generally stated as a percent of the face amount of the loan. The charge is made generally to cover the cost of placing the loan on the books, but may also represent, in part, an adjustment of yield.

loans-in-process The dollar amount of loans on an association's books that has not yet been disbursed.

loan-to-facilitate Loan made to expedite the sale of real estate owned. These loans usually have a higher loan-to-value ratio than regular conventional loans, making them higher risk loans.

member One owning a savings account in, or one borrowing from, an association. In a federally chartered association, a savings member has one vote for each \$100 or fraction thereof in savings up to specified maximums and a borrowing member has one vote (plus his savings vote, if any). Voting rights are not uniform for state chartered associations. Therefore, the state laws and the association's charter and bylaws should be consulted.

mobile facility An association branch office facility contained in a vehicular conveyance that circulates among various geographical areas periodically.

mortgage A pledge or security of particular property for the payment of a debt or the performance of some other obligation. See also **deed of trust**.

mortgage-backed securities Includes bonds issued by FNMA and FHLMC, and pass-through certificates. An association may also issue bonds collateralized by mortgage loans.

mortgage insurance A type of insurance policy by which the insurer agrees to cover the association against loss on a mortgage loan. The amount of loss the insurer agrees to cover is usually limited to a certain percentage of the loan.

mutual associations (mutuals) Associations having no capital stock, in contrast to capital stock associations. Mutual associations are state-chartered or federally-chartered corporations. Ownership rests with the members who elect the board of directors.

National Housing Act Created authority for the FSLIC and the attendant regulations.

National Savings and Loan League One of the two nationwide savings and loan trade organizations. See also **United States League of Savings Associations**.

National Savings and Loan League's Manager's Guide A loose-leaf service published by the National Savings and Loan League covering laws and regulations pertinent to associations.

negotiable certificates of deposit Certificates of deposit issued by an association that are freely negotiable between the holder of the certificate and third parties.

net carrying amount The cost of real estate owned, reduced by related allowances for losses.

open-end mortgage Mortgage permitting additional secured advances under the original mortgage.

PA bulletin Criteria issued by the Federal Home Loan Bank Board pertaining to auditing and reporting requirements for savings and loan associations that must report to the FHLBB.

participation Partial ownership in a loan or group of loans.

passbook Book issued by an association to a borrower or a saver for recording transactions in the customer's account.

passbook loan Loan secured by savings account of member. Also commonly called savings account loan, share loan, dividend-day loan, or dividend-anticipation loan.

pass-through certificates Certificates guaranteed by GNMA representing shares in pools of mortgages insured by the FHA, VA, or Farmers Home Administration. The pools include mortgages with the same interest rate and same approximate maturity. The payback to investors includes both interest and principal, both guaranteed by GNMA. There are minimum trading unit amounts.

permanent stock associations See **capital stock associations**.

points See **loan fee**.

prepayment Payment of a loan before its scheduled maturity.

prepayment penalty Penalty for payment of a loan before its scheduled maturity.

proxy A member's authorization to have another person or committee vote in his stead.

quit-claim deed When the holder of a first lien takes property under a quit-claim deed, as opposed to foreclosure, his title is subject to amounts owing under any other liens on the property. See also **deed**.

real estate owned Property acquired (a) for sale or development or (b) through foreclosure or deed in place of foreclosure (foreclosed real estate).

real estate sold on contract Contract for the sale of property under which the seller retains title until all required conditions (payments) are met, but the property is in the possession of the buyer.

Regulation Q Regulation that governs the maximum amount of interest that can be paid on savings and time deposits.

Regulation Z A comprehensive federal regulation that requires disclosure to borrowers of the finance charge, annual percentage

rate, and other information relating to loans (Truth-in-Lending Act).

repurchase agreements (repos) An agreement whereby an association purchases securities under a stipulation that provides that the seller will repurchase them within a specified time at a specified price.

reserves Reserves typically are general or specific reserves. General reserves include the legal reserves, federal insurance reserve, reserve for contingencies, and reserve for bad debts when this reserve is classified in the equity section of the balance sheet. Such general reserves are considered appropriated (restricted) retained earnings. Specific reserves represent either (a) valuations against asset accounts, for example, allowance for losses or (b) liabilities, for example, bonuses payable on savings accounts.

reverse repurchase agreements (reverse repos) An agreement whereby an association sells securities under a stipulation to repurchase them within a specified time at a specified price.

rule of 78s Use of the sum-of-the-digits method for amortization.

savings account loan See **passbook loan**.

scheduled items Poorly performing assets defined by regulations. They include real estate owned and certain loans and investments.

service corporations Subsidiaries of associations that are authorized to perform related functions, such as an insurance agency, escrow agency, and conveyancing.

share loan See **passbook loan**.

short sales A short sale is a transaction in which an association sells securities, which it has borrowed from a third party, at the current market price. The association agrees to purchase a similar security at a future date to replace the borrowed security. Alternatively, the association may sell securities (which it does not own) at today's market price with a future delivery date. Short sale transactions frequently are collateralized by other securities in the association's portfolio.

short sales against the box Transactions in which the association sells, in a short sale, securities identical to those it presently holds in its portfolio. The association may use the securities it presently holds to make delivery on its short sale.

signature card Card bearing the saving member's signature. The card is kept on file by the association for the purpose of verifying the member's signature when savings are withdrawn. The signature card contains the contract between the saver and the association. Most associations also maintain a signature card file of borrowing members.

specific reserve A statutory reserve established to charge a possible loss against a specific asset. For regulatory purposes, the reserve is shown as a deduction from the related asset in the statement of financial condition.

stock association See **capital stock associations**.

straight mortgage One requiring no payments of principal until maturity. Interest generally is paid periodically.

subordinated debenture Debt instruments issued by an association that are subordinate to savings.

supervisory authority The FHLB for federal associations and other FSLIC insured associations and uninsured members of the Federal Home Loan Bank.

supervisory agent A designated officer of the FHLB who acts in the interests of the FHLBB in regard to matters involving federal and FSLIC-insured associations.

third-party payments Preauthorized payments by an association to third parties (for example, creditors), which are automatically made from a depositor's account without the need of check writing.

title opinion Opinion written by an attorney after examining abstract of title (or perhaps the documents themselves instead of an abstract) in which he states his opinion as to the state of the title to property. See **certificate of title**.

title policy Policy issued by a title insurance company guaranteeing that title to property is as indicated in the policy.

Torrens certificate Certificate issued by registrar of titles, setting forth state of title to property. The certificates are issued in several metropolitan areas, for example, New York, Chicago, and Boston.

trust deed See **deed of trust**.

Truth-in-Lending Act See **Regulation Z**.

undisbursed portion of mortgage loans See **loans-in-process**.

uninsured improvement loan Improvement loan not insured by FHA nor guaranteed by VA.

United States League of Savings Associations One of the two nationwide savings and loan trade organizations. See also **National Savings and Loan League**.

Veterans Administration (VA) insured loan A loan insured or partially guaranteed by the VA pursuant to the Servicemen's Readjustment Act of 1944 as Amended. At the option of the lender, the loan may be insured or partially guaranteed. If the lender expresses no option, the VA processes the loan as a partially guaranteed loan. Virtually all lenders use the partial-guarantee method.

warranty deed See **deed**.

